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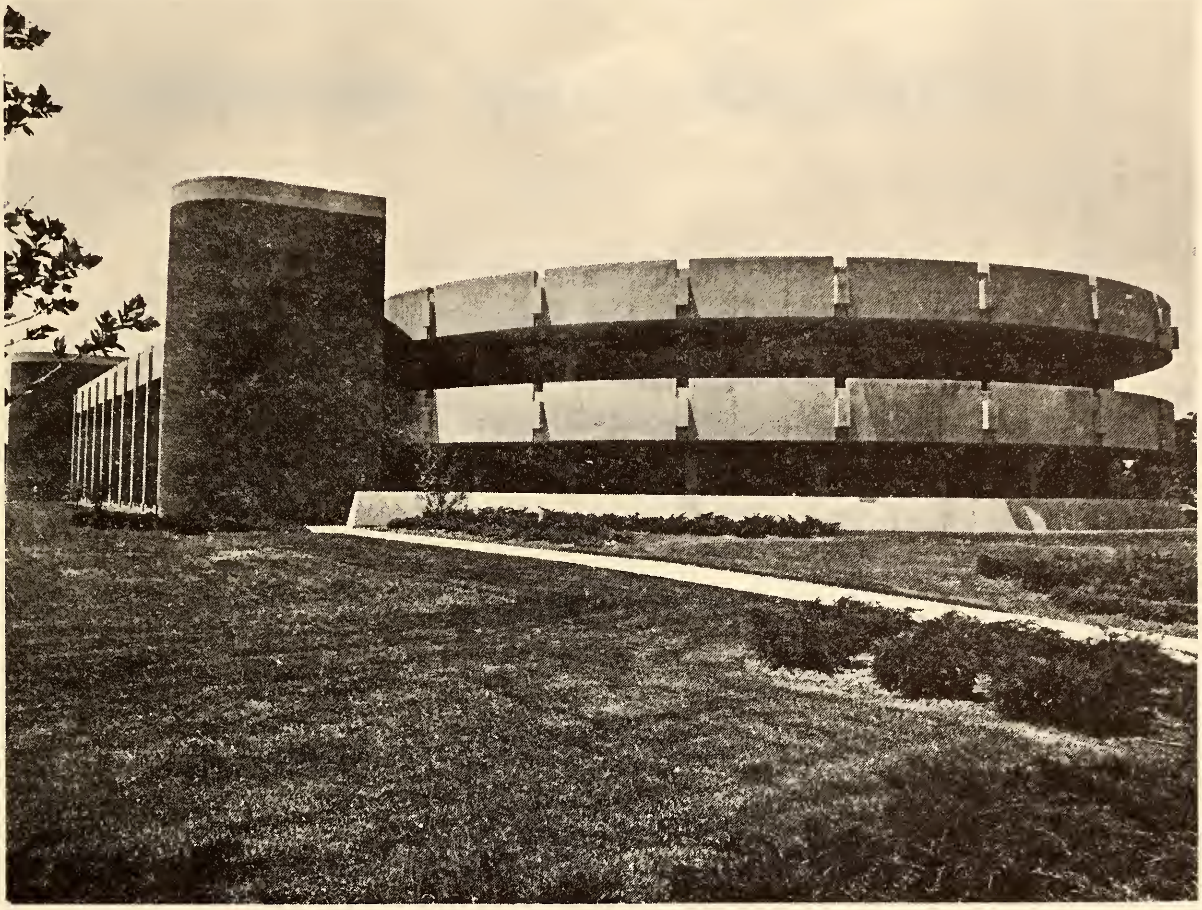

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Rethinking Price-Fixing

Richard S. Wirtz*

I. Introduction

"Price-fixing" by competitors is unlawful per se.[1] This is the best-known rule in antitrust—the one most often enforced in criminal proceedings, and the only one that appreciable numbers of businessmen have been convicted and sentenced to prison for violating. Through years of judicial application to agreements among competitors on the price of what they sell, the rule has acquired something approaching the dignity of a statute.

The rule began as a prohibition upon agreements on price among competitors with substantial collective market power.[2] In *United States v. Socony-Vacuum Oil Co.*,[3] the United States Supreme Court, extrapolating from its earlier decisions, laid down a broader rule: "[A] combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or

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[1]Arizona v. Maricopa County Medical Soc'y, 457 U.S. 332, 342-48 (1982); Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643, 647-50 (1980); Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1, 7-9 (1979); United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940).

In antitrust cases and commentary concerning horizontal restraints, the term "price-fixing" is used in two senses. In the broad sense, it encompasses all arrangements unlawful per se under the rule of the *Socony* case (*see infra* text accompanying note 3). In the narrow sense, it refers to agreements among competitors on the price of what they sell. When the term is used in this Article in the broad sense, it appears in quotation marks.

[2]*See generally* United States v. Trenton Potteries Co., 273 U.S. 392 (1927); United States v. Joint Traffic Ass'n, 171 U.S. 505 (1898); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897); United States v. Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898), *modified*, 175 U.S. 211 (1899).

[3]310 U.S. 150 (1940).

foreign commerce is illegal per se."[4] In dictum, the Court went an important step further. To prove per se unlawful "price-fixing" under section 1 of the Sherman Act,[5] Justice Douglas wrote for the Court in *Socony*, neither power nor effect need be shown:

> It is the "contract, combination or conspiracy, in restraint of trade or commerce" which § 1 of the Act strikes down, whether the concerted activity be wholly nascent or abortive on the one hand, or successful on the other . . . [A] conspiracy to fix prices violates § 1 . . . though no overt act is shown, though it is not established that the conspirators had the means available for the accomplishment of their objective, and though the conspiracy embraced but a part of the interstate or foreign commerce in the commodity . . . [Price-fixing agreements] are all banned because of their actual or potential threat to the central nervous system of the economy.[6]

In subsequent cases involving agreements among competitors to fix the price of what they sold, the Court routinely applied the per se rule against "price-fixing," holding the agreements unlawful with and without proof of power and effect, and regardless of their purported justifications.[7] In 1951, in *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons,*

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[4]*Id.* at 223.

The courts have applied the per se rule against "price-fixing" to a wide variety of horizontal restraints on price competition, including agreements to restrict or eliminate price advertising (United States v. Parke Davis & Co., 362 U.S. 29 (1960)), trade credit (Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643 (1980)), quantity discounts (United States v. United Liquors Corp., 149 F. Supp. 609 (W.D. Tenn. 1956)), and trading stamps (United States v. Gasoline Retailers Ass'n, 285 F.2d 688 (7th Cir. 1961)); agreements on minimum markups (California Retail Grocers & Merchants Ass'n v. United States, 139 F.2d 978 (9th Cir. 1944)); basing-point pricing systems (FTC v. Cement Inst., 333 U.S. 683 (1948)); agreements to circulate uniform list prices (Plymouth Dealers' Ass'n v. United States, 279 F.2d 129 (9th Cir. 1960)) and "suggested" prices (Northern Cal. Pharmaceutical Ass'n v. United States, 306 F.2d 379 (9th Cir. 1962)); and boycotts of discounters (United States v. General Motors Corp., 384 U.S. 127 (1966)).

The rule has also been applied to a class of agreements that are beyond the scope of the term as used in this Article—agreements among firms on the price they will pay for what they buy. *See, e.g.*, Mandeville Island Farms, Inc. v. American Crystal Sugar Co., 334 U.S. 219 (1948).

[5]Ch. 647, 26 Stat. 209 (1890) (current version codified at 15 U.S.C. § 1 (1982)).

[6]*Socony*, 310 U.S. at 224 n.59.

[7]United States v. McKesson & Robbins, Inc., 351 U.S. 305 (1956); United States v. New Wrinkle, Inc., 342 U.S. 371 (1952); Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, 340 U.S. 211 (1951); United States v. National Ass'n of Real Estate Boards, 339 U.S. 485 (1950); United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948); United States v. United States Gypsum Co., 333 U.S. 364 (1948); United States v. Line Material Co., 333 U.S. 287 (1948); United States v. Frankfort Distilleries, Inc., 324 U.S. 293 (1945); United States v. Masonite Corp., 316 U.S. 265 (1942). *See generally* Comment, *The Per*

Inc.,[8] the Court unanimously affirmed a judgment against two competing distillers for setting *maximum* prices by agreement, on a record "devoid of evidence . . . that the defendants were capable of . . . influencing the market price of whisky or that they [had] actually produced an effect on the market. . . ."[9] By 1956, the controlling doctrine could be summarized in sweeping terms: "[Price-fixing] is conclusively presumed to be unreasonable . . . [regardless of] whether the motives of the participants are good or evil; . . . whether the participants possess market control; whether the amount of interstate commerce affected is large or small; or whether the effect of the agreement is to raise or to decrease prices."[10]

Unlike most of antitrust law, "thou shalt not agree with thy competitors on price" is easy to understand and remember. The essential wisdom of the rule is plain. For a generation after *Socony* the Court acknowledged no exceptions, other than cases involving conduct authorized by other federal statutes[11] or exempted from Sherman Act condemnation by state action.[12] Pre-*Socony* decisions, insofar as they qualified the general prohibition against horizontal agreements on price, were ignored.[13] Exceptions recognized by lower courts in reported cases[14] were exceedingly rare.

Se Illegality of Price-Fixing—Sans Power, Purpose, or Effect, 19 U. Chi. L. Rev. 837, 859-60 & nn.127-29 (1952).

[8]340 U.S. 211 (1951).

[9]*See* Comment, *supra* note 7, at 848.

[10]United States v. McKesson & Robbins, Inc., 351 U.S. 305, 310 (1956) (footnotes omitted).

[11]*See, e.g.*, Gordon v. New York Stock Exch., Inc., 422 U.S. 659 (1975) (stock exchange agreements fixing commission rates held to be immune from antitrust attack by virtue of grant of regulatory powers to the SEC in the Securities Exchange Act of 1934); United States v. National Ass'n of Sec. Dealers, 422 U.S. 694 (1974) (implied immunity from antitrust liability for certain price-fixing agreements in connection with the distribution and sale of mutual fund shares held conferred by the Maloney Act of 1938 and the Investment Company Act of 1940).

[12]*See, e.g.*, Parker v. Brown, 317 U.S. 341 (1943) (price-fixing by raisin growers as part of a comprehensive program of marketing controls authorized by state statute and supervised by a state commission held not to violate the Sherman Act).

[13]In *Socony*, the Court distinguished the two leading cases sustaining agreements among competitors on price, Board of Trade v. United States, 246 U.S. 231 (1918) (Chicago Board of Trade) and Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933), on the ground that unlike the agreement in *Socony*—a large-scale buying program organized by major oil companies to eliminate the "excess" supply of gasoline on the market—the agreements in the earlier cases had not been entered into for the purpose or with the effect of raising the general level of market prices. 310 U.S. at 216, 217. As the rule announced in *Socony* evolved into a prohibition against fixing prices, irrespective of purpose, power, or effect, the Court simply ignored the contrary implications of *Chicago Board of Trade* and *Appalachian Coals*.

[14]*See, e.g.*, United States v. Columbia Pictures Corp., 189 F. Supp. 153 (S.D.N.Y.

Now, in three cases, the Court has reopened the question of per se illegality for agreements among competitors on price that have some potential to "'increase economic efficiency and render markets more rather than less competitive.'"[15] In *Broadcast Music, Inc. v. CBS, Inc.*,[16] the Court unanimously declined to hold a horizontal agreement on price in the music copyright industry unlawful per se.[17] In *Arizona v. Maricopa County Medical Society*,[18] a bare plurality of the Court held two agreements among competing physicians setting maximum fees unlawful per se, over a vigorous dissent.[19] In the third case, *NCAA v. Board of Regents*,[20] seven Justices declared a horizontal agreement on the price of college football television rights unlawful under the rule of reason, expressly declining to condemn it under the per se rule.[21]

These developments represent a partial triumph for proponents of the view that the objective of the antitrust laws is to promote economic efficiency. For more than twenty years, proponents of this view have contended that agreements among competitors on prices should not invariably be unlawful because a flat ban condemns, without good reason, practices capable of contributing significantly to economic efficiency.[22] All four major recent opinions—the majority opinions in *Broadcast Music* and *NCAA* and the plurality and dissenting opinions in *Maricopa*—treat economic efficiency as a value entitled to recognition in evaluating the "competitive significance" of horizontal restraints on price competition under section 1.

1960); United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953). The cases are collected and discussed in Allison, *Ambiguous Price Fixing and the Sherman Act: Simplistic Labels or Unavoidable Analysis?*, 16 Houston L. Rev. 761 (1979).

[15]Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1, 20 (1979) (citing United States v. United States Gypsum Co., 438 U.S. 422, 441 n.16 (1978)).

[16]441 U.S. 1 (1979).

[17]*Id.* at 10. In determining whether a practice is unlawful per se as price-fixing, Justice White wrote for the Court, it is not conclusive that "two or more potential competitors have literally 'fixed' a 'price.'" *Id.* at 9.

[18]457 U.S. 332 (1982).

[19]*Id.* at 357. The dissent, authored by Justice Powell, was joined by Chief Justice Burger and Justice Rehnquist.

[20]468 U.S. 85 (1984).

[21]*Id.* at 100-01, 120.

[22]The pioneering article is Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division* (parts 1 & 2), 74 Yale L.J. 775 (1965), 75 Yale L.J. 373 (1966). *See also* R. Bork, The Antitrust Paradox: A Policy at War with Itself 263-79 (1978); Bowman, *Contrasts in Antitrust Theory: II*, 65 Colum. L. Rev. 417 (1965); Easterbrook, *Maximum Price Fixing*, 48 U. Chi. L. Rev. 886 (1981); Gerhart, *The Supreme Court and Antitrust Analysis: The (Near) Triumph of the Chicago School*, 1982 Sup. Ct. Rev. 319; Liebeler, *Intrabrand "Cartels" Under* GTE Sylvania, 30 UCLA L. Rev. 1 (1982); Comment, *Fixing the Price Fixing Confusion: A Rule of Reason Approach*, 92 Yale L.J. 706 (1983).

With respect to the kinds of practices involved in these cases—price-fixing agreements accompanying potentially procompetitive collaboration on matters other than price—the law is now seriously muddled. In *Broadcast Music*, the Court implied that per se condemnation is reserved for practices with which the courts have had considerable experience.[23] Shortly thereafter, in *Maricopa*, the Court held precisely to the contrary, striking down on traditional principles an agreement on price that was quite different in some respects from any in the precedents.[24] In *Maricopa*, the Court seemed to interpret *Broadcast Music* as holding narrowly that an agreement among competitors on the price of a product they produce jointly is not unlawful per se where such an agreement is "necessary to market the product at all."[25] In *NCAA*, the Court found that the competitors' agreement on price was unnecessary to the marketing of their jointly produced product, but applied the rule of reason nevertheless.[26] Two commentators have summarized the lesson of these cases this way: "Horizontal price-fixing is always illegal; but not all horizontal price-fixing is price-fixing, and some types of price-fixing may thus be upheld."[27]

This Article is an appreciation and a critique of the Supreme Court's exploratory efforts in these cases to reduce the costs of the per se rule against "price-fixing" in terms of over-deterrence, without destroying its effectiveness. This Article deals primarily with price-fixing in its narrow sense—agreements among competitors on specific prices[28] or on procedures by which specific prices are fixed.[29] All three cases—*Broadcast Music*, *Maricopa*, and *NCAA*—involved agreements of these types. As will be noted, however, the Court's decisions in these cases have important implications for the law of "price-fixing" in general.

From the opinions, it is clear that the Court has not embraced the theory that the antitrust laws exist to promote economic efficiency, but

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[23]441 U.S. at 8, 9, 19 n.33.

[24]The Court attempted to reconcile the two positions by differentiating between the application of an established per se rule and the creation of a new one. Explaining that the facts in *Maricopa* fell within the established per se rule, the Court went on to state that "a *new per se* rule is not justified until the judiciary obtains considerable rule-of-reason experience with the particular type of restraint challenged." 457 U.S. at 349 & n.19.

[25]*Id.* at 355-56. The quotation is from *Broadcast Music*, 441 U.S. at 23.

[26]468 U.S. at 100, 113-14.

[27]Marks & Jacobson, *Price-Fixing: An Overview*, 30 ANTITRUST BULL. 199, 256 (1985).

[28]*See supra* note 1. Prohibited agreements that fix specific prices include agreements on both minimum and maximum prices.

[29]An example is an agreement among competitors to delegate the function of setting prices for the group to a single firm. *See, e.g.*, United States v. Masonite Corp., 316 U.S. 265 (1942) (agreement among manufacturers of a patented product to charge no less than the price fixed by the manufacturer-patentee).

is instead proceeding on the premise that when competitors conspire or combine, the law's first concern is to protect the economic interests of consumers in competition in the marketplace. On this premise, the appropriate measure of legality in price-fixing cases is not whether the combination makes a positive or negative contribution to economic efficiency, but whether it promotes or suppresses competition. The Court's opinions in this regard are consistent, and its position has strong support both in the legislative history of the Sherman Act and in the long-standing tradition of judicial interpretation of the Act.

At the doctrinal level, nothing in these cases implies any relaxation of the per se rule as applied to conventional agreements among competitors on price. Straight price-fixing, unaccompanied by any other potentially procompetitive agreement, is per se illegal. The problem addressed in these cases is the problem of the agreement on price that functions as part of a larger potentially procompetitive scheme. In this Article several possible interpretations of the decisions are explored. The Article concludes that the cases are best read to stand for the proposition that agreements among competitors on price are unlawful per se, unless the parties are also engaged in potentially procompetitive collaboration on matters other than price, and the agreement on price performs some essential function in that collaboration other than raising prices. Where those conditions are met, the agreement is ordinarily to be judged under the rule of reason. It is unlawful per se only if further inquiry discloses that any potential gains to consumers from the price-fixing are so slight, in relation to the competitive risks that the costs of rule-of-reason adjudication outweigh the benefits.

II. The Cases

Two earlier Burger Court decisions supply an important part of the predicate for the decisions in *Broadcast Music*, *Maricopa*, and *NCAA*. They are *Continental T.V., Inc. v. GTE Sylvania, Inc.*,[30] in which the Court abolished a per se rule for the first time in the history of the Sherman Act,[31] and *National Society of Professional Engineers v. United States*,[32] in which the Court applied the rule of reason to an arrangement both lower courts had held unlawful under the broad per se rule of *Socony*.[33]

Provided with a chance to clarify the per se rule announced some years earlier in *United States v. Arnold, Schwinn & Co.*,[34] the Court

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[30]433 U.S. 36 (1977).

[31]*Id.* at 58.

[32]435 U.S. 679 (1978).

[33]*Id.* at 695-96.

[34]388 U.S. 365 (1967). In *Schwinn*, the Court held that the per se status of vertically imposed territorial restrictions under § 1 differed depending on whether the restrictions

in *Sylvania* instead annulled it. Though the Court's holding was limited to vertical non-price restraints, the explicit recognition in the opinion that efficiencies that result from a restraint may have a significant bearing on its reasonableness, and the criteria put forth for the formulation and evaluation of per se rules, had considerably broader implications.

Throughout its opinion, the Court emphasized competition. In the evaluation of any class of competitive restraints, Justice Powell wrote for the Court, "[t]he probability that anticompetitive consequences will result from [the] practice and the severity of those consequences must be balanced against its procompetitive consequenses."[35] Vertical non-price restrictions, he noted, "reduce intrabrand competition by limiting the number of sellers of a particular produce competing for the business of a particular group of buyers."[36] On the other hand, such restrictions may enable manufacturers to realize marketing efficiencies which may in turn enable them to "compete more effectively"[37] vertical restraints may facilitate new entry,[38] or they may revive a failing or "faltering" firm.[39]

The issue, then, was whether vertical territorial restraints, notwithstanding their potential competitive virtues, should be held unlawful per se because they almost invariably restrain some competition. Just five years earlier, the Court had declared horizontal territorial restraints unlawful per se.[40] In *Sylvania*, the Court rejected the argument that vertical restraints should be similarly classified.[41]

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in question involved a technical restraint on alienation. Sales by a manufacturer to its distributors subject to territorial restrictions on resale were held to be unlawful *per se*. Similar restrictions imposed on distributors "[w]here the manufacturer retains title, dominion and risk with respect to the product and the position and function of the dealer . . . are . . . indistinguishable from those of an agent or salesman of the manufacturer" were held to be lawful if reasonable. *Id.* at 379, 380.

[35]*Sylvania*, 433 U.S. at 50 n. 16.

[36]*Id.* at 54.

[37]*Id.* at 55.

> For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products.

Id.

[38]*Id.* at 55.

[39]*Id.* at 58 n.29.

[40]United States v. Topco Assocs., Inc., 405 U.S. 596 (1972). The Court, in an opinion by Justice Marshall, held that horizontal territorial restraints could not be defended on the ground that they enhanced interbrand competition: "Our inability to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another sector is one important reason we have formulated *per se* rules." *Id.* at 609-10.

[41]The Court distinguished *Topco*, without further explanation, on the ground that

"[T]he prevailing standard of analysis" in section 1 cases, Justice Powell wrote for the court, is the rule of reason.[42] Any departure from that standard "must be based upon demonstrable economic effect rather than . . . formalistic line drawing."[43] The fact that in some instances a particular practice may be procompetitive on balance does not ensure rule-of-reason treatment: "a *per se* rule reflects the judgment that such cases are not sufficiently common or important to justify the time and expense necessary to identify them."[44] In the case of vertical non-price restrictions on distribution, however, there was no basis for such a judgment. Noting that the great weight of scholarly opinion lay against the *Schwinn* per se rule,[45] that the lower courts had been devoting considerable ingenuity to devising ways around it,[46] and that there was an almost total lack of support for the rule from any quarter, the Court overruled it.[47]

The Court in *Sylvania* did not say, nor did it imply, that the primary concern of antitrust law is the promotion of economic efficiency. Throughout the opinion, the Court treated efficiency as an instrumental value—a means to the end of promoting competition. Nor did the Court "indicate that the *per se* rule should be limited to those transactions which do not have any potential for efficiency creation."[48] The closest the Court came to such a pronouncement (not really very close) was to state that where a practice has procompetitive potential—perhaps because it generates efficiencies that enable firms to compete more effectively—per se condemnation is inappropriate without a careful weighing of the costs and benefits.

In the term following *Sylvania*, the Court decided *National Society of Professional Engineers v. United States*.[49] The Society sought to defend a canon of ethics forbidding its members from engaging in competitive bidding. Its argument, which emphasized the canon's contribution to public health and safety, was also in a way an efficiency defense. Competitive bidding among engineers, it argued, leads to shoddy work-

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it concerned horizontal and not vertical restraints. *Sylvania*, 433 U.S. at 57 n.27.

[42] *Id.* at 49. Justice Powell then quoted the classic formulation of the rule from Chicago Board of Trade v. United States, 246 U.S. 231, 238 (1918): "The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition." *Sylvania*, 433 U.S. at 49.

[43] *Sylvania*, 433 U.S. at 58-59. This remark appears to have been directed at the distinction in *Schwinn* between sale and non-sale transactions.

[44] *Id.*

[45] *Id.* at 47-48, 47 n.13.

[46] *Id.* at 48 & n.14.

[47] *Id.* at 58.

[48] Liebeler, *supra* note 22, at 1-2.

[49] 435 U.S. 679 (1978).

manship, which in turn leads to higher project costs and disastrous structural failures.[50] A ban on competitive bidding would ensure that consulting engineers would commit the resources necessary to do the job well, and would yield substantial public benefits in terms of safety and material well-being.[51]

The Court, however, rejected the defense as a "frontal assault on the basic policy of the Sherman Act."[52] Justice Stevens wrote for the Court:

> The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services. "The heart of our national economic policy long has been faith in the value of competition." . . . The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers.[53]

Of course, individual engineers were free to offer clients high-quality engineering services. Some clients might well reject these offers; of those, some might eventually regret it. But under the Sherman Act, neither the Society nor the Court was free to substitute its judgment for the clients' as to what they *should* want.

The Society's defense based on the rule of reason, Justice Stevens noted, was predicated on a misunderstanding of the rule: "Contrary to its name, the Rule does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint's impact on competitive conditions."[54] The Court had consistently so held since *Standard Oil Co. v. United States*,[55] the seminal rule-of-reason case:

> From Mr. Justice Brandeis' opinion for the Court in *Chicago Board of Trade* to the Court opinion written by Mr. Justice Powell in [*Sylvania*], the Court has adhered to the position that the inquiry mandated by the Rule of Reason is whether the challenged agreement is one that promotes competition or one that suppresses competition . . . [T]he purpose of the analysis

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[50]Brief for Petitioner at 27-35.
[51]*Id.* at 27-35, 54-55.
[52]*Professional Engineers*, 435 U.S. at 695.
[53]*Id.*
[54]*Id.* at 688.
[55]221 U.S. 1 (1911).

> is to form a judgment about the competitive significance of the restraint; it is not to decide whether a policy favoring competition is in the public interest . . . .[56]

The Society's restraint suppressed competition and did not promote it. The proffered defense amounted to the assertion that in the defendant's market, "competition itself is unreasonable."[57] Under the Sherman Act, there could be no such defense.[58]

Viewing the *Sylvania* and *Professional Engineers* opinions in retrospect, one can see a distinction taking shape between efficiencies that promote or enhance competition and efficiencies that do not. In the subsequent opinions dealing with explicit horizontal agreements on price—*Broadcast Music*, *Maricopa*, and *NCAA*—the Court affirmed the importance of the distinction, and began to work out its implications for the law of price-fixing.

A. Broadcast Music, Inc. v. CBS, Inc.

In *Broadcast Music*,[59] the Columbia Broadcasting System attacked as "price-fixing" the long-established practice of blanket licensing in the music copyright industry. For many years, owners of copyrights in musical works had combined to issue blanket copyright licenses through performing rights organizations such as the American Society of Composers, Authors and Publishers (ASCAP) and Broadcast Music, Inc. (BMI).[60] The blanket license authorized licensees to perform any work in the licensing organization's inventory for a single fee—usually a flat fee, but sometimes a fee computed on the licensee's revenues. For many years, CBS, as proprietor of the CBS television network, had purchased blanket licenses from ASCAP and BMI. After negotiations for license renewal broke down in 1969, CBS sued ASCAP, BMI, and their members and affiliates, contending that blanket licensing violated the Sherman Act. At the time of suit, ASCAP's inventory included more than three million works; BMI's contained more than one million.

Blanket licensing necessarily entailed agreement among sellers of competing products[61] on the price of sale. Every blanket licensee bought rights at a price fixed by a process which eliminated competition among

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[56] *Professional Engineers*, 435 U.S. at 691-92.

[57] *Id.* at 696.

[58] *Id.* Justices Blackmun and Rehnquist concurred separately.

[59] 441 U.S. 1 (1969).

[60] Unless otherwise indicated, the facts are taken from the opinion of the district court, CBS, Inc. v. ASCAP, 400 F. Supp. 737 (S.D.N.Y. 1975).

[61] The district judge found "that musical compositions are substantially interchangeable and that for any proposed use there are several, if not scores, of compositions which are equally suitable." *Id.* at 751-52.

the individual licensors. True, the licensors did not agree on the prices at which they would separately license their works. Nevertheless, CBS argued persuasively, blanket licensing clearly presented the normal risks of price enhancement from pricing-fixing. The copyright owners affiliated with each defendant had enormous collective leverage and they knew it.[62] Even assuming they remained willing in fact to issue individual licenses, the profitability of blanket licensing would tend almost inevitably to raise the price of those licenses. Such an effect, however, would be difficult to prove. The whole point of the per se rule was to eliminate the necessity of detailed economic proof in cases of this kind.[63] Unless, CBS argued, the per se rule's prohibition on agreements among competitors on prices allowed for exceptions—and since *Socony* in 1940 the Court had acknowledged none—blanket licensing was unlawful without regard to any purported justifications.[64]

Despite the force of these arguments, CBS' position in the lawsuit was, in some ways, peculiarly unappealing. The practice it was attacking had unique and well-documented advantages not only for licensors, but also for many licensees. For firms engaged in small-scale "performances" of copyrighted musical works—radio stations, roller rinks, night clubs, concert halls—it was vastly more economical to license performance rights in bulk than through individual bilateral licenses. On the licensors' side, there were additional economies in monitoring and enforcement. The products here, copyright licenses, were creatures of a federal statute enacted primarily to promote progress in science and useful arts by establishing financial incentives for the creation and publication of works of authorship, including musical works.[65] To the extent that blanket licensing helped composers and publishers reach a larger market and enforce their rights against small users who otherwise would have purchased no license at all, infringing on copyrights, blanket licensing furthered the policy of the copyright statute.[66] Both the Department of Justice and the lower courts had approved of blanket licensing as a practical alternative to individual bilateral licensing in the industry.[67] On

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[62]*See* Brief for Respondent at 62-85, 139-43 & Addendum A.

[63]*See id.* at 78-79.

[64]*See id.* at 50-59. BMI argued that "[w]hen presented with joint delegation of pricing decisions to an agency controlled by a group of competitors, . . . [the] Court has looked to the purpose, effect and industry context of such agreements, and often upheld them under the rule of reason." Brief for Petitioner at 18-19. As authority for that proposition, however, BMI could cite no decision more recent than *Appalachian Coals*. *See supra* note 13.

[65]*See* Mazer v. Stein, 347 U.S. 201, 219 (1954); 1 M. Nimmer, Nimmer on Copyright § 1.03[A] (1986).

[66]*See Broadcast Music*, 441 U.S. at 18-19.

[67]*See id.* at 10-15.

their face, at least, the blanket licensing arrangements were nonexclusive; there was no explicit agreement among copyright owners to license performance rights by this means alone, and there was no agreement on what they would charge for licenses sold individually. Though CBS attacked blanket licensing as "price-fixing," what it really wanted was not individual bilateral licensing, but rather bulk licenses from BMI and ASCAP in a different and cheaper form.[68] That greatly increased the awkwardness of its position; if blanket licensing was unlawful per se, any form of licensing by the copyright owners acting in concert was equally unlawful.[69]

The district judge, after a lengthy trial, dismissed the complaint on all counts.[70] A divided panel of the Second Circuit reversed, holding the practice of blanket licensing unlawful per se.[71] The Supreme Court, by a vote of eight to one, reversed the Second Circuit and remanded the case for further consideration under the rule of reason.[72]

Before Justice White, writing for the Court, could reach the merits of the practice, he had to address the per se rule. "[A]greements among competitors to fix prices," he wrote, "are among those concerted activities that the Court has held to be within the *per se* category. But easy labels do not always supply ready answers."[73] Determining whether a practice is unlawful per se as "price-fixing"

> is not a question simply of determining whether two or more potential competitors have literally "fixed" a "price." . . . When two partners set the price of their goods or services they are literally "price-fixing," but they are not *per se* in violation of

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[68]*See CBS*, 400 F. Supp. at 747 & n.7.

[69]*Cf. Broadcast Music*, 441 U.S. at 17 n.27.

[70]*CBS*, 400 F. Supp. at 783. Judge Lasker distinguished the precedents cited by CBS on the ground that in this case, the competing sellers, ASCAP and BMI, were offering buyers a choice: buyers might either purchase the seller's products separately at competitively determined prices or purchase them together at a package price. *Id.* at 748-49.

[71]CBS, Inc. v. ASCAP, 562 F.2d 130 (2d Cir. 1977). "[T]he very availability of the blanket license," Judge Gurfein wrote for the majority, "involves the fixing of a collective price, which must, inevitably, permit the copyright owner to *choose* the blanket license as his medium of licensing in preference to individual bargaining. The blanket license dulls his incentive to compete." *Id.* at 139 (italics in original).

[72]*Broadcast Music*, 441 U.S. at 24-25. Justice Stevens dissented. In his view, on the record before the Court, the defendant's refusal to license performance rights *en bloc* in any form other than a blanket license was plainly unlawful under the rule of reason. *Id.* at 26 n.4, 35 (Stevens, J., dissenting).

On remand, the Second Circuit affirmed the district court's exoneration of the defendants under the rule of reason, on the ground that CBS had failed to show that blanket licensing of music copyrights to television networks had any actual anticompetitive effect. CBS, Inc. v. ASCAP, 620 F.2d 930, 939 (2d Cir. 1980).

[73]*Broadcast Music*, 441 U.S. at 8 (footnote omitted).

> the Sherman Act. . . . Thus, it is necessary to characterize the challenged conduct as falling within or without that category of behavior to which we apply the label "*per se* price fixing."[74]

Though he framed the inquiry in terms of "redeeming competitive virtues,"[75] throughout much of the opinion, Justice White implied that efficiency was the redemptive factor. "The blanket license," he noted, "accompanies the integration of sales, monitoring, and enforcement against unauthorized copyright use . . . . Individual sales transactions in this industry are quite expensive, as would be individual monitoring and enforcement, especially in light of the resources of single composers."[76] Though the economies were greater for some classes of licensees than others, they were present to some degree in every transaction:

> even for television network licenses, ASCAP reduces costs absolutely by creating a blanket license that is sold only a few, instead of thousands, of times . . . . [A] bulk license of some type is a necessary consequence of the integration necessary to achieve these efficiencies, and a necessary consequence of an aggregate license is that its price must be established.[77]

Had the opinion ended on that note, *Broadcast Music* would stand as an exception to the general prohibition against agreements among competitors on price for arrangements that have the potential to create efficiencies, regardless of their competitive effects. However, at the close, the opinion took a turn. Following the pattern established by *Sylvania* and *Professional Engineers*, the Court tied its observations about the efficiencies of the practice before it to a conclusion regarding the impact of the practice on competition. "[W]e have some doubt," Justice White wrote, "about the extent to which this practice threatens the 'central nervous system of the economy,' . . . that is, competitive pricing as the free market's means of allocating resources."[78] Blanket licensing was efficient; it was also procompetitive.

> This substantial lowering of costs . . . differentiates the blanket license from individual use licenses. The blanket license is composed of the individual compositions plus the aggregating service. Here, the whole is truly greater than the sum of its parts; it is, to some extent, a different product. . . . Many consumers

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[74]*Id.* at 9.
[75]*Id.* at 13.
[76]*Id.* at 20.
[77]*Id.* at 21 (footnote omitted).
[78]*Id.* at 23 (quoting United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 226 n.59 (1940)).

> clearly prefer the characteristics and cost advantages of this marketable package . . . . ASCAP is not really a joint sales agency offering the individual goods of many sellers, but is a separate seller offering its blanket license, of which the individual compositions are raw material. ASCAP, in short, made a market in which individual composers are inherently unable to compete fully effectively.[79]

The composers and publishers had not agreed to license their works exclusively through BMI and ASCAP; they had not agreed on what they would charge for their products sold separately. Though CBS argued that blanket licensing made individual licensing impracticable, the district court had found that "there was no legal, practical, or conspiratorial impediment to CBS's obtaining individual licenses; CBS, in short, had a real choice."[80] CBS' argument thus came down to the contention that the law forbids competitors to combine under any circumstances to provide a product that cannot be provided without agreement among them on the price at which it will be sold. No precedent compelled such a holding, and the Court declined to so hold.

B. Catalano, Inc., v. Target Sales, Inc.

In the term after *Broadcast Music*, the Court, in *Catalano, Inc. v. Target Sales, Inc.*,[81] struck down *per curiam* an agreement among local beer wholesalers to deny trade credit to retailers. Credit, the Court observed, is part of the price of a product. In economic effect, the agreement was similar to an agreement among competing sellers to eliminate discounts. Because it was "merely one form of price-fixing," the agreement was "conclusively presumed illegal without further examination . . . ."[82] Unlike the blanket licensing in *Broadcast Music*, the restraint on price competition in *Catalano* involved no potentially procompetitive collaboration of any kind on matters other than price. From the standpoint of competitive benefits, it was scarcely different from an ordinary industry-wide price-fixing agreement.[83]

In that respect, the next case, *Arizona v. Maricopa County Medical Society*,[84] was distinguishable from *Catalano* and much more like *Broadcast Music*. Nevertheless, the Court held the practice before it unlawful per se.

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[79] *Id.* at 21-23 (footnotes omitted).
[80] *Id.* at 23-24.
[81] 446 U.S. 643 (1980).
[82] *Id.* at 650.
[83] *Id.* at 648-49.
[84] 457 U.S. 332 (1982).

C. Arizona v. Maricopa County Medical Society

Maricopa, like *Broadcast Music*, involved an explicit agreement among competitors on price. Physicians in Maricopa and Pima Counties in Arizona who were members of "foundations for medical care" organized under the auspices of their county medical associations periodically adopted, by majority vote, maximum fee schedules to be used in conjunction with insurance plans offered by certain insurers. Patients insured under these plans were guaranteed "full dollar coverage"[85] for medical expenses incurred within the range of services subject to the plans, with a wide choice of doctors. The participating physicians agreed to bill the insurance companies no more than the maximum scheduled fees for services rendered to insured patients. Once adopted, the fee schedules were circulated throughout the membership, which in Maricopa County comprised seventy percent of the practicing doctors.[86]

The state of Arizona brought suit under section 1 of the Sherman Act against the two "foundations" and their county medical societies to enjoin further concerted fixing of fees by the doctors. Under the guise of protecting consumer interests, the state contended, the defendants were raising the general level of medical fees in the state's two most populous counties.[87] The district court denied the state's motion for partial summary judgment, but certified for interlocutory appeal the question "'whether the . . . agreements, which contain the promise to abide by maximum fee schedules, are illegal per se . . . .'"[88] By a vote of two to one, a panel of the Ninth Circuit affirmed.[89]

On the record before the Court in *Maricopa*, the doctors' commitment to maximum fees reduced the costs of calculating risks and computing

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[85]"Full dollar coverage" signifies 100% reimbursement for covered services, subject to a deductible.

[86]*Maricopa*, 457 U.S. at 340. The Pima County percentage was disputed. *Id.* n.8. However, the Court treated the Maricopa and Pima County arrangements as identical for all practical purposes and held both unlawful without regard to market share. *Id.* at 340.

[87]The state argued:

> Although the foundations' fee schedules supposedly set only maximum prices and purportedly are limited to foundation endorsed health plans, they actually have had an inflationary impact which belies their characterizations as "maximum" fee schedules and which reaches much further than formally endorsed plans . . . [T]he foundations' fee schedules have been set at levels higher than both the average and median fees of Arizona doctors as determined by the foundations' own price surveys. . . . And, once the fee schedules are established through the elaborate process of price surveys and formal voting, foundation members revise their prices so that some 85 to 95 percent charge prices at or above those established by the fee schedules.

Brief for Petitioner at 7.

[88]457 U.S. at 336-37 (quoting the Court of Appeals' statement of the issue).

[89]Arizona v. Maricopa County Medical Soc'y, 643 F.2d 553 (9th Cir. 1980).

the payments due on insured claims. Though the insurers were capable of negotiating maximum fee commitments with the physicians individually, arguably, greater economies were possible if the doctors fixed the fees by agreement among themselves. Like the blanket licenses in *Broadcast Music*, the insurance plans constituted an attractive product—medical insurance with guaranteed "full dollar coverage" and a choice among doctors practicing privately in the community—different from anything that could be offered by the participants acting independently. Moreover, without agreements by the physicians to charge no more than a fixed maximum, the program probably would not have worked. In the absence of a fixed maximum, physicians would take advantage of guaranteed 100% reimbursement by unilaterally raising fees. Costs and premiums would then increase to the point that the insurance plans would no longer be attractive to subscribers.[90]

Nevertheless, by a vote of four to three with two abstentions,[91] the Supreme Court reversed both lower courts and held the agreement unlawful per se.[92]

Writing for the plurality—Justices Brennan, White, Stevens, and Marshall—Justice Stevens began his analysis with the established per se rule of per se illegality for horizontal price-fixing. Since *Standard Oil* in 1911, he noted, the Court had consistently held that once "price-fixing" was proved, the section 1 inquiry was over: a "conclusive presumption" brought the case within the statute.[93] Since at least 1952, it had been clear that "horizontal agreements to fix maximum prices [stood] on the same legal . . . footing as agreements to fix minimum or uniform prices."[94] Nothing in *Maricopa*—the fact that the competitors were professionals, the fact that the judiciary lacked much experience in evaluating "price-fixing" claims in the health care industry, or the fact that the arrangement had some potential procompetitive effects—called for any special treatment.[95] The case was entirely different from *Broadcast Music*. In *Broadcast Music*, price-fixing by competitors was

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[90]"[I]n the absence of the maximum price constraints individual fee hikes would pig the program to death. The 100 per cent coverage program . . . would not be able to survive in competition with other ways of providing health care." W. Liebeler, Antitrust Advisor § 1.29, at 28 (2d ed. Supp. 1983). The Court apparently so assumed. *See* 457 U.S. at 352. There is no indication that the Court assumed or should have assumed from the record before it that the maximum fee for each physician for each procedure had to be the same.

[91]Justices Blackmun and O'Connor took no part in the decision.

[92]*Maricopa*, 457 U.S. at 357.

[93]*Id.* at 344-45 (quoting Standard Oil Co. v. United States, 221 U.S. 1, 65 (1911)).

[94]*Id.* at 348 (citing Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211 (1951)) (footnote omitted).

[95]*Id.* at 348-51.

"a 'necessary consequence' of the creation of [a] blanket license."[96] In *Maricopa*, although some understanding between insurers and individual participating physicians on maximum fees was essential to enable the insurers to offer full dollar coverage,[97] there was no necessity whatsoever that the *doctors* combine to fix the fees. The insurers themselves were fully capable "not only of fixing maximum reimbursable prices but also of obtaining binding agreements with providers guaranteeing the insured full reimbursement of a participating provider's fee."[98]

Justice Powell, joined by the Chief Justice and Justice Rehnquist, dissented in *Maricopa*. In *Sylvania*, he wrote, the Court had held that as part of the inquiry required to determine whether a practice is unlawful per se, "a court must determine whether the procompetitive economies that the arrangement purportedly makes possible are substantial and realizable in the absence of such an agreement."[99] On the abbreviated record before the Court in *Maricopa,* it was impossible to make that determination. Given the posture of the case, the Court was required to accept the defendants' contentions, supported by evidence in the record, that their arrangement "'serves as an effective cost-containment mechanism that has saved patients and insurers millions of dollars.'"[100] The insurance plans, Justice Powell thought, were like the blanket licenses in *Broadcast Music* in every important respect: "Each involved competitors and resulted in cooperative pricing. Each . . . was prompted by the need for better service to the consumers. And each arrangement makes possible a new product by reaping otherwise unattainable effi-

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[96]*Id.* at 355-56 (quoting *Broadcast Music*, 441 U.S. at 21).

[97]"It is true," Justice Stevens wrote,

> that a binding assurance of complete insurance coverage—as well as most of the respondents' potential for lower insurance premiums [through cost savings in risk calculation and the computation of benefits]—can be obtained only if the insurer and the doctor agree in advance on the maximum fee that the doctor will accept as full payment for a particular service. Even if a fee schedule is therefore desirable, *it is not necessary that the doctors do the price fixing.*

Id. at 352 (emphasis added) (footnotes omitted).

[98]*Id.* at 353. Justice Stevens continued:

> The most that can be said for having doctors fix the maximum prices is that doctors may be able to do it more efficiently than insurers. The validity of that assumption is far from obvious, but in any event there is no reason to believe that any savings that might accrue [from having the doctors fix the prices] would be sufficiently great to affect the competitiveness of these kinds of insurance plans. It is entirely possible that the potential or actual power of the foundations to dictate the terms of such insurance plans may more than offset the theoretical efficiencies upon which the respondents' defense ultimately rests.

Id. at 353-54 (footnotes omitted).

[99]*Id.* at 362 (Powell, J. dissenting).

[100]*Id.* at 360 (quoting the plurality opinion at 342).

ciencies . . . ."[101] Because the state had failed to prove that the defendants had "entered a plainly anticompetitive combination without a substantial and procompetitive efficiency justification," the Court (in the dissenters' view) should have affirmed the ruling of the trial court on the issue of per se illegality.[102]

Quite clearly, there were two distinctions between the agreements on price in *Broadcast Music* and *Maricopa* that could reasonably be regarded as important. First, unlike the composers and publishers in *Broadcast Music*, the physicians in *Maricopa* fixed the prices of services which they sold separately. The foundation arrangements therefore involved all of the conventional competitive risks of horizontal agreements fixing maximum prices.[103] Second, in *Broadcast Music,* the product literally could not be sold without explicit agreement among the competitors on price; in *Maricopa,* this was not true. As the plurality pointed out, assuming the insurance plans could not be sold without commitments by individual doctors to maximum fees, there was no reason why the doctors had to do the fee-fixing. The insurers could do it. Although this might be less economical, that was a far cry from saying that the plans could not be provided otherwise.[104] The effect of a decree imple-

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[101]*Id.* at 364-65 (footnotes omitted).

[102]*Id.* at 366.

[103]As Justice Stevens observed: "The agreement under attack is an agreement among hundreds of competing doctors concerning the price at which each will offer his own services to a substantial number of consumers." *Id.* at 356-57. The maximum fee schedules for the doctors' services were adopted by the doctors themselves. Once adopted, they were circulated throughout the group of participating physicians. Thereafter, there was no incentive for any individual physician to charge less than the "maximum" fee to any patient insured under the plans. As the United States pointed out, appearing as amicus curiae:

> Doctors have no financial incentive to charge insured patients less than the maximum fee because the insurers, in order to obtain foundation approval, previously have agreed to pay any fee up to that maximum. Moreover, insured patients have no direct incentive to select a doctor who charges less. The doctor's charge is paid by the insurer, and an individual patient's premiums do not vary on the basis of the fees charged by a particular doctor.

Brief for the United States as Amicus Curiae at 8. Moreover, by virtue of a provision in the foundation scheme forbidding member physicians "to discriminate in billing Foundation insured patients as compared to non-Foundation insured patients," *see* Brief for Respondents at 44, the participating physicians were apparently required, if they charged the agreed-upon "maximum" fees to patients insured under the special plans, to charge no less to patients throughout the community. The *Broadcast Music* arrangements, as Justice White had carefully noted, had no such feature. *See supra* text accompanying note 80.

[104]*Maricopa*, 457 U.S. at 352-54. Had it been seriously argued that the effect of transferring the fee-setting responsibility from the foundations to the insurers would have been to raise the administrative costs of the program to the point that the plans would have been priced out of the market, the economic impact of per se condemnation in

menting the Court's decision would be to shift the initiative in the determination of maximum fees from the foundations, created by physicians whose interests lay in raising general fee levels, to the insurers, whose interests lay (with consumers) in keeping fees down. The desired product could then be provided on a competitive basis, without incurring the risks inherent in an explicit agreement among competitors on maximum prices.[105]

The fact remained that there was evidence that the "foundation" method of establishing maximum fee schedules was economical, and that the resulting economies were "procompetitive" in the sense in which the dissenters obviously meant the term, i.e., the economies benefited consumers.[106] "As we have noted," Justice Powell wrote, "the antitrust

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Maricopa and *Broadcast Music* might have been the same. Nobody, however, raised that argument.

[105]The Court's opinion has been criticized on this point for "formalism." "For purposes of demonstrable economic effect," Professor Liebeler has written, "what difference does it make whether the doctors are 'canvassed' by a foundation of their own creation which then deals with the various insurers or whether the doctors are 'canvassed' by the various insurers directly?" W. Liebeler, *supra* note 90, at 32.

Implicit in the opinion, I believe, is this answer, supplied by the Department of Justice:

> [T]he agreements here at issue serve to inhibit unilateral actions by insurers to restrain costs through prescription of their own maximum payments to physicians . . . . When competing physicians do not set prices, insurers have an economic incentive to negotiate fee schedules that will minimize costs for medical services rendered to their subscribers, for they maximize their own profits by doing so. And when there is competition or potential competition among insurers to minimize medical payments, the benefits of their actions accrue to the public. Insurers who succeed in limiting their costs are able to offer lower premiums than insurers who do not . . . .
>
> When all insurers are faced with a single price schedule fixed by doctors through foundations, however, competition has a much more limited potential for minimizing consumer costs . . . .

Brief for the United States as Amicus Curiae at 8-9.

Prof. Liebeler's criticism, however, continues:

> Even from a formalistic standpoint, Justice Stevens' suggestion does not avoid the "problem" of a concert amongst the providers. There is plenty of authority for the proposition that if the doctors entered into agreements with the insurers, knowing that other doctors were doing the same thing, they have entered into a horizontal concert of action.

W. Liebeler, *supra* note 90, at 32. This is a substantial point, which the Court did not address. A response consistent with its opinion would be: The record before the Court failed to show that direct horizontal price-fixing, in the form of explicit agreements among physicians on fees, was essential to the provision of any product. If another case were to come before the Court on a record demonstrating that the product in question could be provided only by means of horizontal price-fixing in some less pernicious form, the Court, following *Broadcast Music*, would withhold per se condemnation. *See supra* note 90.

[106]Throughout the dissenting opinion, Justice Powell distinguished implicitly between

laws are a 'consumer welfare prescription.'"[107] The record did not *compel* a finding that consumers[108] were benefiting, through lower fees and insurance premiums, from the economies specifically attributable to the concerted fixing of fees; for all the record showed, as the plurality pointed out, the practice resulted in higher fees, not lower ones. But why should the case not be remanded for trial to find out? Given the possibility of procompetitive efficiencies from the arrangement, it could certainly be argued that it was wrong to "condemn this arrangement forthwith under the Sherman Act, a law designed to *benefit* consumers."[109]

In *Maricopa*, the Court, by a narrow margin, rejected the proposition that the prospect of procompetitive efficiencies from an agreement among competitors to fix prices in and of itself justifies an exception to the general prohibition. Affirming and applying the per se rule, the plurality never fully explained why, after *Sylvania* and *Broadcast Music*, the existence of some procompetitive efficiencies should not be recognized as a complete defense to a charge of per se illegality. On the other hand, the dissent, invoking the principles of *Sylvania* and *Broadcast Music*, never squarely addressed the issue of whether economies arising out of the mere process of fixing prices should be the basis for an exception to the per se rule.

D. NCAA v. Board of Regents

Two years after *Maricopa*, the Court held that the rule of reason applied to a set of controls on the licensing of college football television rights that included the fixing of prices by competitors in combination.[110] Though the Court's opinion in *NCAA* shed new light on the nature of the defendant's burden of justification in a rule-of-reason case involving an agreement among competitors on price, it also raised further questions concerning the criteria for exceptions to the general rule of per se illegality.

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efficiencies that are "procompetitive" and efficiencies that are not. *See, e.g., supra* text accompanying notes 99-102. This point is overlooked when *Broadcast Music* and the dissent in *Maricopa* are read together for the proposition that no practice should be condemned per se if it has the potential to create significant efficiencies. *See, e.g.*, W. LIEBELER, *supra* note 90, at 28-32; Gerhart, *supra* note 22, at 344-48.

[107] *Maricopa*, 457 U.S. at 367 (Powell, J., dissenting) (quoting Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979)).

[108] Lest he be misunderstood in his use of the word "consumer," Justice Powell defined it in the context of the case: "The term 'consumer'—commonly used in antitrust cases and literature—is used herein to mean persons who need or may need medical services from physicians." *Id.* at 360 n.5. The misunderstanding he apparently wished to avoid is discussed below. *See infra* text accompanying notes 139-45.

[109] *Maricopa*, 457 U.S. at 360 (emphasis in original).

[110] NCAA v. Board of Regents, 468 U.S. 85 (1984).

Since 1953, the National Collegiate Athletic Association had imposed controls on the broadcasting of football games by its member colleges and universities.[111] These controls, instituted originally to protect live attendance at games, evolved over time into a device for increasing television broadcast revenues and distributing them widely among the member schools. In 1977, the NCAA granted the ABC television network the exclusive right for four years to televise regular-season football games between NCAA schools on a network basis, on terms which severely limited the number of times any school could appear. In 1981, a new four-year television plan granted shared exclusive rights on similar terms to ABC and CBS.[112] When a group of NCAA member schools with major football programs, dissatisfied with the plan, secured a competing offer from NBC, the NCAA threatened retribution. Two of the dissidents, the Universities of Oklahoma and Georgia, sued the NCAA, alleging antitrust violations, including per se unlawful "price-fixing."

The NCAA controls fixed prices at two levels. The 1981 plan, developed pursuant to an NCAA bylaw and ratified by the membership, was essentially an agreement among competitors to bundle competing products[113] and sell the bundle at a single price. The price—called the "minimum aggregate fee" in the network contracts—was negotiated by the member schools jointly, through the NCAA as their agent. Subject to severe constraints, the contracts left the final choice of games to the networks. By a custom so long-standing that it was regarded as part of the agreement, however, once a network had selected a given game, the compensation paid to the participating schools was determined ac-

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[111]Except as otherwise noted, the facts are taken from the opinion of the district court, Board of Regents v. NCAA, 546 F. Supp. 1276 (W.D. Okla. 1982).

At the time of suit, the NCAA was composed of approximately 900 members, most of them four-year colleges and universities. *Id.* at 1282-83. These members will be referred to here as "colleges" or "schools."

[112]*Id.* at 1283-84, 1289-93. By the terms of the 1981 plan, member schools were limited to six appearances on regular network television, no more than four of which could be nationally televised. With the NCAA's permission, member schools could contract for "exception telecasts," but only on a local basis and only if certain conditions were met. These restrictions were designed to guarantee increased television exposure for schools with lesser-known football programs by curtailing exposure of other games viewers would probably have chosen to watch, i.e., games between the prominent NCAA Division I teams. To ensure that the networks did in fact broadcast games between lesser-known teams, each network was required, over each two-year period, to schedule appearances for at least 82 NCAA member schools.

The NCAA plan also provided for a contract granting the Turner Broadcasting System the exclusive right to cablecast live performances of NCAA games. *Id.* at 1291-92.

[113]In the marketing of college football television rights, colleges are natural competitors: the rights are valuable, the demand for them is finite, and in a free market, colleges would vie with one another for the revenues available from their sale. *See id.* at 1298.

cording to the NCAA's "recommended" schedule. The schedule set uniform prices for national and regional telecasts for each of the NCAA's three divisions.

At the close of a six-week trial, the district judge entered judgment for the plaintiffs. The NCAA controls were found to be anticompetitive both on their face and in effect. They yielded an array of televised games entirely different from the one a free market, responsive to consumer preferences, would have produced, and they grossly distorted the prices paid for the rights to broadcast individual games. The district court held the controls unlawful as "price-fixing" and as unreasonable restraints under the rule of reason.[114] A divided panel of the Tenth Circuit sustained both rulings.[115]

In the Supreme Court, the NCAA argued that the controls were highly procompetitive. College football, though in some ways unique in its appeal to television viewers and thus attractive to advertisers and broadcasters, had to compete with a variety of other televised entertainments. To enable college football to compete effectively, it was crucial that NCAA members provide a large and varied "menu" of "close and exciting games" every season.[116] The appearance requirements and limitations at the heart of the NCAA plan thus served a desirable and procompetitive function:

> It is undisputed that the extent of television exposure is very important to colleges in recruiting new players and attracting alumni donations. Thus the increase in the number of teams shown on national or regional broadcasts puts the teams on more competitive footing in recruiting new players and financing their programs.
>
> The result is that colleges will be more evenly matched on the field, and more games will be close and exciting. The more close and exciting games there are, the more people will watch college football on TV, where it competes with other entertainments . . . .[117]

The NCAA hinted that if it were required to drop the controls, televised college football as a sport attractive to viewers might cease to exist. It

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[114] *Id.* at 1319. The district judge also held the television plan unlawful as monopolization and a group boycott. *Id.* at 1326.

[115] Board of Regents v. NCAA, 707 F.2d 1147 (10th Cir. 1983). The court of appeals affirmed on the monopolization count, reversed on the group boycott count, and remanded for reconsideration of the decree. *Id.* at 1156, 1160, 1162.

[116] Brief for the Petitioner at 22 nn.11 & 20.

[117] *Id.* at 20.

argued that the decision on how best to package the product ought to be left to members of the NCAA; as the producers of televised college football, they were entitled to the same choice among marketing methods as were the producers of a prime-time soap opera.[118]

By unanimous vote, the Supreme Court declined to hold the NCAA television controls unlawful per se. By a vote of seven to two, however, the Court held the controls unreasonable under the rule of reason.[119]

On its face, the NCAA television plan was plainly anticompetitive.[120] Unlike the ASCAP-BMI blanket licensing arrangements, the NCAA controls not only fixed prices, but restricted output and severely restrained competition in the market for the competitors' products sold separately.[121] Nevertheless, on the per se issue, the Court bypassed these distinctions. Ordinarily, Justice Stevens wrote for the Court, horizontal price-fixing "is presumed unreasonable without inquiry into the particular market context in which it is found. Nevertheless, we have decided that it would be inappropriate to apply a *per se* rule to this case."[122] The decision

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[118]"Dynasty" was mentioned. *Id.* at 23. Defendant also argued that the controls were procompetitive because they economized on production and transaction costs, discouraged free rides, and increased live attendance at the games. *Id.* at 22-27.

[119]Justice White, joined by Justice Rehnquist, dissented. *NCAA*, 468 U.S. at 120. Arguing that "limiting the number of television appearances by any college is an essential attribute of a balanced amateur athletic system," the dissenters thought the NCAA plan was defensible both on conventional rule-of-reason grounds and as a means of promoting the organization's non-commercial purposes. *Id.* at 128, 130-31 (White, J., dissenting).

[120]*Id.* at 113.

[121]Justice Stevens in fact emphasized that point: "In *Broadcast Music*, [u]nlike this case, . . . each individual remained free to sell his own music without restraint. Here production has been limited, not enhanced. No individual school is free to televise its own games . . . ." *Id.* at 114-15 (footnote omitted).

The cases were also distinguishable on the ground that in *NCAA*, unlike *Broadcast Music*, the competitors' agreement fixed the prices of the parties' respective products. *See supra* text following note 110. The Court found this to be particularly objectionable. *NCAA*, 468 U.S. at 105-08 & nn.30 & 33. This aspect of the agreement, however, served primarily as a formula for distributing the minimum aggregate fee among the member schools, much like the ASCAP-BMI procedures for the distribution of the proceeds of blanket licensing.

The Court pointed out a third possible distinction:

> The District Court did not find that the NCAA's television plan produced any procompetitive efficiencies which enhanced the competitiveness of college football television rights; to the contrary it concluded that NCAA football could be marketed just as effectively without the television plan. . . . In light of these findings, it cannot be said that "the agreement on price is necessary to market the product at all." *Broadcast Music*, 441 U.S. at 23.

Id. at 114 (footnote omitted). The Court's analysis holds, provided that "the product" is college football television rights. If "the product" is viewed as exclusive package licenses of college football television rights, the case suddenly looks a good deal more like *Broadcast Music*. *See id.* at 129-30 (White, J., dissenting).

[122]*Id.* at 100.

was based, he emphasized, not on a lack of judicial experience with the practice, but on the fact that "this case involves an industry in which horizontal restraints on competition are essential if the product is to be available at all."[123] Many NCAA rules were designed to preserve amateurism in college football—rules restricting payments to athletes, rules requiring them to attend classes, etc. Those rules were procompetitive: they made the sport more attractive to game-goers and television viewers, and differentiated it from sports like minor league baseball. Because, indeed, "the great majority of the NCAA's regulations enhance competition . . ., a fair evaluation of [the television controls'] competitive character requires consideration of the NCAA's justifications . . . ."[124]

Under the rule of reason, a practice like the one before the Court—a "naked restriction on price or output"—was unlawful, absent a procompetitive justification, regardless of whether the parties to it had collective market power.[125] The NCAA controls constituted "horizontal price fixing, perhaps the paradigm of an unreasonable restraint of trade."[126] Under the controls in operation, on the undisputed findings of the district court,

> [p]rice is higher and output lower than they would otherwise be, and both are unresponsive to consumer preference. . . . This latter point is perhaps the most significant, since "Congress designed the Sherman Act as a 'consumer welfare prescription.'" . . . A restraint that has the effect of reducing the importance of consumer preference in setting price and output is not consistent with this fundamental goal . . . .[127]

Because the restraints had that effect, the NCAA bore "a heavy burden of establishing an affirmative defense. . . ."[128]

The Court held that the NCAA failed to sustain its burden. To the extent that balancing the strength of NCAA football teams enhanced

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[123]*Id.* at 101.

[124]*Id.* at 103.

[125]*Id.* at 109-10. The cases cited by the Court in support of this proposition shed some light on what the Court meant by "naked restrictions." They included not only cases involving agreements among competitors fixing the prices of their products sold separately, but cases like *Catalano*, *Professional Engineers*, and *Socony*, which involved other practices that necessarily interfered with price competition if they had any effect at all. *Id.* at 110 & nn.40-41.

Because the NCAA had market power, *see id.* at 111-12, the proposition in the text was dictum. Carefully stated and supported by extensive case citations, it was dictum of a fairly high order.

[126]*Id.* at 100.

[127]*Id.* at 107 (footnotes omitted).

[128]*Id.* at 113.

public interest in the games, it was procompetitive, and the NCAA's interest was "legitimate and important."[129] As a means to that end, however, the television controls were ineffectual[130] and overbroad.[131] There was no evidence that they produced any greater measure of team balance than would a variety of other regulations the NCAA apparently had the power to impose,[132] none of which would involve direct horizontal restraints on price and output—"the paradigmatic examples of restraints of trade that the Sherman Act was intended to prohibit."[133]

Thus in *NCAA*, unlike *Broadcast Music*, the fact that the arrangement was held to qualify for rule-of-reason rather than per se treatment did not affect the outcome. The question remains: since the NCAA controls were distinguishable on their face from the agreements in *Broadcast Music*, why did the Court withhold per se condemnation? Although some restraints on competition might be essential to the existence of college football and the marketing of college football television rights, how could that justify the fixing of prices, which so clearly was not? Unless the mere fact that such conduct might have procompetitive effects in a particular context exempts it from per se condemnation—which the Court in *Maricopa* held was not the case—how could the fact that other restraints imposed by the same parties were procompetitive have any bearing at all?

Perhaps, on the per se issue, there was another more persuasive approach to the same result. As the Court noted in *Broadcast Music*, package sales are potentially procompetitive. That is true even where, as in *NCAA*, the sales are exclusive package sales and the contents of the package are products that could otherwise be sold in competition with one another.[134] On its face, the exclusive package licensing in this case had procompetitive potential. Clearly there could be no package

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[129]*Id.* at 117.

[130]Justice Stevens had no difficulty in providing an example: "It seems unlikely . . . that there would have been a greater disparity between the football prowess of Ohio State University and that of Northwestern University in recent years without the NCAA's television plan." *Id.* at 118 n.62. That though was merely one illustration of the more general problem: "The District Court found that in fact the NCAA has been strikingly unsuccessful if it has indeed attempted to prevent the emergence of a 'power elite' in intercollegiate football." *Id.*; *see* Board of Regents v. NCAA, 546 F. Supp. at 1310-11.

[131]*NCAA*, 468 U.S. at 119.

[132]*Id.*

[133]*Id.* at 107-08. The Court also noted that the controls were "not related to any neutral standard"—a comment, apparently, on the fact that the NCAA had suggested no criterion by which a court could determine whether its members had abused their collective power over price and output, but was instead essentially requesting complete discretion—and that if the controls were lifted, on the findings of the district court, consumption of the product (televised college football) would increase. *Id.* at 118, 119-20.

[134]*See, e.g.*, C. Kaysen & D. Turner, Antitrust Policy—An Economic and Legal

sale of the competing products, exclusive or otherwise, without an agreement among the competitors on the price. Though there were plainly other techniques available by which the NCAA member schools could apportion television revenues and balance teams, the relationships involved were quite complex—far more complex than those in *Maricopa*, where it was clear on the pretrial record that an alternative arrangement which did not involve an explicit horizontal agreement on price would yield comparable benefits at far less risk. On the record before it, the Court could reasonably conclude that the circumstances warranted a full inquiry into the reasonableness of the restraint—and that the district judge, having conducted such an inquiry, had reached the right result.

III. Policy and Doctrine

To get a good sense of what is happening to the law of "price-fixing," these cases must be read at two levels. At the policy level, the opinions start from the premise that the law's primary objective is to protect consumers' economic interests in competition in the marketplace. This is a conservative premise, which has strong support in both the legislative history of the Sherman Act and the leading cases applying section 1 to horizontal agreements on price. What is new in the recent cases is the Court's receptivity to the argument that competitive benefits to consumers from horizontal agreements on prices are in some instances substantial and worth preserving. In *Broadcast Music* and *NCAA*, but not in *Maricopa*, that argument prevailed. The result is a change in doctrine—the express recognition of exceptions to the general rule of per se illegality.

A. Policy

At the heart of these opinions are two premises: (1) the first concern of the Sherman Act is to protect the economic interests of consumers in competition among producers and distributors; (2) the curtailment of competition by agreement among producers or distributors runs contrary to the law's objectives unless it in some way enhances or promotes competition, thereby increasing the economic well-being of consumers.

The Sherman Act, Justice Stevens wrote for the Court in *Professional Engineers*,

> reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services. . . . The assumption that competition is the best method

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Analysis 152-53 (1959); L. Sullivan, Handbook of the Law of Antitrust §§ 77, 104 (1977).

> of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—. . . are favorably affected by the free opportunity to select among alternative offers.[135]

Competition is the free market's means of applying constant pressure to producers and distributors to satisfy consumers' desires. Competition in the medical profession creates incentives for doctors to employ innovative and challenging procedures and to experiment with new techniques.[136] Competition in the market for college football television rights ensures that televised games are the ones viewers really want to see.[137] Price competition is more than just a device for making products more affordable; it is an important mechanism for communicating consumer preferences to producers and distributors who, in turn, are rewarded for satisfying them; it is "the central nervous system of the economy."[138]

The thrust of the cases is neatly summarized in a phrase which recurs in the opinions: the Sherman Act was intended by Congress to be a "consumer welfare prescription." The phrase comes from the writings of Prof. (now Judge) Robert Bork, a leading exponent of the Chicago school of antitrust analysis.[139] Adherents of the Chicago school—proponents of the view that the objective of the antitrust laws is to promote economic efficiency—have commended the Court for adopting the phrase.[140] As the Court uses it, however, in the context of a horizontal restraint on price competition, the phrase does not refer, as it generally does in the literature of the Chicago school,[141] to the welfare of everyone potentially affected by the restraint, including the owners of participating firms and purchasers of goods and services in remote markets. The Court uses the phrase to refer specifically to the welfare of consumers of the product subject to the restraint: i.e., purchasers of consumer

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[135] 435 U.S. 679, 695 (1978).

[136] Arizona v. Maricopa County Medical Soc'y, 457 U.S. 332, 348 (1982).

[137] *NCAA*, 468 U.S. at 105-06, 107 n.34.

[138] United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 224 n.59 (1940), *quoted in Professional Engineers*, 435 U.S. at 692, *and Broadcast Music*, 441 U.S. at 23.

[139] "The legislative histories of the antitrust statutes, therefore, do not support any claim that Congress intended the courts to sacrifice consumer welfare to any other goal. The Sherman Act was clearly presented and debated as a consumer welfare prescription." R. Bork, *supra* note 22, at 66.

[140] *See, e.g.*, R. Posner & F. Easterbrook, Antitrust Cases, Economic Notes and Other Materials 154 (2d ed. 1981); Baxter, *Responding to the Reaction: The Draftsman's View*, 71 Calif. L. Rev. 618, 619 n.6 (1983).

[141] *See, e.g.*, sources cited *supra* notes 139-40; Gerhart, *supra* note 22, at 330-32; Liebeler, *supra* note 22, at 13-16; Muris, *The Efficiency Defense Under Section 7 of the Clayton Act*, 30 Case W. Res. L. Rev. 381, 384-86 (1980); Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 Am. Econ. Rev. 18 (1968).

goods who have paid inflated prices as a result of a conspiracy among manufacturers to fix prices;[142] television viewers who are prevented from watching those football games they would most like to see by an agreement among colleges that restrains competition in the sale of broadcasting rights;[143] and purchasers of health insurance whose premiums might or might not be reduced if the maximum fees for physicians' services were set by the method claimed to be the most economical, *viz.*, explicit agreement among the physicians themselves.[144] As a "consumer welfare prescription"—"a law designed to benefit consumers"[145]—the Act's first concern in a case involving price-fixing by competitors is the welfare of consumers who stood to benefit from competition among the fixers and who may now be injured by its curtailment.

The second recurring theme in the cases concerns the kinds of effects that will justify a competitive restraint. The traditional formulation of the rule of reason in *Chicago Board of Trade* is vague and open-ended.[146] The cases discussed here narrow the range of inquiry to the impact of the challenged practice on "competitive conditions."[147] A practice unreasonably restrains trade if it suppresses competition and does not promote it.[148] The virtues that can redeem a competitive restraint are "redeeming competitive virtues;"[149] the efficiencies that count are "procompetitive efficiencies."[150] A restraint that "enhance[s] the competitiveness" of a product may be defensible.[151] A restraint whose defense rests on the proposition that in a particular commercial context "competition itself is unreasonable," however, is doomed.[152]

Under these formulations, the critical question becomes: What effects of a competitive restraint are "procompetitive" effects? The opinions leave the answer to inference. From the Court's initial premise, it would seem to follow that if an agreement restrains competition, its defense under the Act must be on the ground that in some way it also stimulates

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[142]Reiter v. Sonotone Corp., 442 U.S. 330, 343-44 (1979).

[143]*NCAA*, 468 U.S. at 107 n.34. *See supra* text accompanying note 127.

[144]*Maricopa*, 457 U.S. at 367 (Powell, J., dissenting). *See supra* notes 106-09 and accompanying text.

[145]*Maricopa*, 457 U.S. at 360 (Powell, J., dissenting) (italics deleted).

[146]*See* Board of Trade v. United States, 246 U.S. 231, 238 (1918), *quoted in part*, *supra* note 42, *criticized*, R. Bork, *supra* note 22, at 41-47.

[147]*Professional Engineers*, 435 U.S. at 690 & n.15 (quoting Standard Oil Co. v. United States, 221 U.S. 1, 58 (1911)); *see* Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 51-56 (1977) (discussed *supra*, text accompanying notes 34-48).

[148]*Professional Engineers*, 435 U.S. at 691 (citing *Sylvania*, 433 U.S. at 49 n.15.).

[149]*Broadcast Music*, 441 U.S. at 13.

[150]*NCAA*, 468 U.S. at 114; *Maricopa*, 457 U.S. at 362, 363, 366 (Powell, J., dissenting) (discussed *supra* notes 106-09 and accompanying text).

[151]*NCAA*, 468 U.S. at 114.

[152]*Id.* at 117 (quoting *Professional Engineers*, 435 U.S. at 696).

competition, thereby increasing the benefits to consumers from the competitive process.

On the whole, the cases support that proposition. Restraints that in some way also facilitate competition and enhance the overall benefits to consumers are "procompetitive;" restraints that do not, are not. In *Professional Engineers*, the defendants' ban on competitive bidding proved to be designed not to help the suppliers of engineering services satisfy consumers' desires, but to make it more difficult for price-conscious buyers to get what they wanted without increasing in any way the alternatives available to buyers willing to pay for high quality. It failed the test.[153] In *Broadcast Music,* the Court praised blanket licensing for its efficiency in general; the opinion also emphasized that the practice enabled individual and bulk licenses to be sold in competition with one another, giving buyers "a real choice."[154] In *Maricopa*, the plurality and the dissenters apparently agreed that the fixing of medical fees by explicit agreement among physicians in connection with the provision of a new form of health insurance would be procompetitive if it were essential to make the insurance marketable on competitive terms, or if it introduced efficiencies that resulted in lower premiums to consumers; they disagreed on whether the potential procompetitive effects of the specific practice involved were sufficient to justify an exception to the general rule.[155] In *NCAA*, the Court indicated that it would regard the defendant's restraints on the sale of college football television rights by member schools as procompetitive to the extent that they increased consumption of the product by making it more attractive to consumers; the Court held, however, that the defendant had failed to satisfy the burden of justification on that ground.[156]

In its emphasis in these cases on the economic interests of consumers in competition, the Court has been paying tribute to a very old tradition. To the proponents of vigorous antitrust legislation in the Congress that passed the Sherman Act, injury to consumers resulting from the suppression of competition by powerful combinations of competitors was a central concern.[157] The most frequent and ardent complaint against the trusts was that they used their power to restrict output and raise prices to consumers. Senator Sherman himself never wavered from his position

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[153]*See supra* text accompanying notes 49-58.

[154]*See supra* text accompanying notes 75-80.

[155]*See supra* text accompanying notes 93-109.

[156]*See supra* text accompanying notes 129-33.

[157]The evidence is marshalled in Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 Hastings L.J. 65, 82-96 (1982). *See also* Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 J. Law & Econ. 7, 14-20 (1966).

that all combinations "designed, or which tend, to advance the cost of the consumer" of articles of commerce should be unlawful.[158] Other spokesmen in both houses were harsh and unsparing in their condemnation of combinations of potential competitors who, by eliminating competition among themselves, raised prices and rates and "ble[d] and fleece[d] the people."[159] In the course of debate, Senator Sherman and others emphasized that they were not opposed in principle to combinations of capital and labor in the form of corporations, partnerships, and the like, because such combinations tended to "lessen the cost of production, and bring within the reach of millions comforts and luxuries formerly enjoyed by thousands."[160] It was combinations that stifled competition and raised prices to consumers that were objectionable—and they remained objectionable even if they lowered production costs.[161] Senator Sherman observed of the trusts:

> It is sometimes said of these combinations . . . that they reduce prices to consumers by better methods of production, but all experience shows that this saving of cost goes to the pockets of the producer. The price to the consumer depends upon the supply, which can be reduced at pleasure by the combination.[162]

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[158]*See* Bork, *supra* note 157, at 15-16 (quoting S. 1, 51st Cong., 1st Sess. § 1, 21 Cong. Rec. 1765 (1890)). Though the bill that ultimately passed Congress as the Sherman Act was drafted by others, Sherman was a central figure in the debate. Sherman's views, Judge Bork has stated in his classic study of the legislative history, "are crucial to an understanding of the intent underlying the law that bears his name." Bork, *supra*, at 14.

[159]The quotation is from the speech of Rep. Anderson of Kansas, 21 Cong. Rec. 5959 (1890).

> [D]uring the debates Senator Sherman termed monopolistic overcharges . . . "extorted wealth" . . . . Congressman Wilson complained that the beef trust "robs the farmer on the one hand and the consumer on the other." Representative Fithian declared that the trusts were "impoverishing" the people through "robbery." Senator Hoar declared that monopolistic pricing was "a transaction the direct purpose of which is to extort from the community . . . wealth which ought to be generally diffused over the whole community."

Lande, *supra* note 157, at 94-95 (footnotes omitted).

[160]21 Cong. Rec. 2457 (1890) (remarks of Sen. Sherman).

[161]Judge Bork concluded that Congress intended to condemn all mergers resulting in monopoly. Bork, *supra* note 157, at 11, 25. Lande in his more recent study similarly concluded:

> [T]he evidence suggests that Congress was unwilling to subordinate its . . . distaste for trusts and monopolists to the goal of corporate efficiency when the efficiency gains would be retained by the monopolist.
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> . . . .
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> . . . [C]ongressional endorsement of trusts' efficient operations stopped when consumer prices rose, and the legislature withheld approval from combinations that, while yielding more efficient methods of competition, also produced higher consumer prices.

Lande, *supra* note 157, at 83, 90-91.

[162]21 Cong. Rec. 2460 (1890). Senator Sherman, Judge Bork has noted, "stressed

These arguments substantially shaped the law of "contract, combination [and] conspiracy . . . in restraint of trade"[163] as applied to horizontal price-fixing. In the seminal price-fixing decisions of the 1890's, the Court, noting that price-fixing by powerful firms in combination tended to raise prices to consumers by eliminating competition in much the same fashion as the trusts, concluded that Congress had intended the same principles to apply to both and held the price-fixing agreements unlawful without regard to the reasonableness of the prices.[164] In the 1911 *Standard Oil* case, the Court, summarizing the concerns that had prompted the passage of the Sherman Act, emphasized "the dread of enhancement of prices and of other wrongs which it was thought would flow from [any] undue limitation on competitive conditions . . . ,"[165] i.e., the classic evils of monopoly from the consumer's standpoint: "1. The power which the monopoly gave to the one who enjoyed it to fix the price and thereby injure the public; 2. The power which it engendered of enabling a limitation on production; and, 3. The danger of deterioration in quality of the monopolized article. . . ."[166] In *Standard Oil*, the Court expressly approved its holdings in the early price-fixing cases: "[C]onsidering the contracts or agreements, their necessary effect and the character of the parties by whom they were made, they were clearly restraints of trade within the purview of the statute. . . ."[167]

The proposition that the law's first concern in price-fixing cases is to protect the interests of consumers in competition is far from new. The novelty in the recent cases lies in the fact that the Court has reopened the question of what rule will best protect those interests.

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the legality of efficiency repeatedly . . . . The only limit he urged to the creation of efficiency by combination was justified explicitly in terms of consumers welfare. He thought combinations of monopolistic size would not pass their efficiencies on to consumers." Bork, *supra* note 157, at 26-27.

[163]Sherman Act § 1, 15 U.S.C. § 1 (1982).

[164]*See* United States v. Trans-Missouri Freight Ass'n., 166 U.S. 290, 322-26 (1897); *see also* Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899); United States v. Joint-Traffic Ass'n, 171 U.S. 505 (1898).

[165]Standard Oil Co. v. United States, 221 U.S. 1, 58 (1911). Compare the following passage from Apex Hosiery Co. v. Leader, 310 U.S. 469 (1940), a decision contemporaneous with *Socony*:

> [The Sherman Act] was enacted in the era of "trusts" and of "combinations" of businesses and of capital organized and directed to control of the market by suppression of competition in the marketing of goods and services . . . . The end sought was the prevention of restraints to free competition in business and commercial transactions which tended to restrict production, raise prices or otherwise control the market to the detriment of purchasers or consumers of goods and services, all of which had come to be regarded as a special form of public injury.

Id. at 492-93 (footnote omitted).

[166]*Standard Oil*, 221 U.S. at 52.

[167]*Id.* at 65.

B. *The Per Se Rule*

An absolute prohibition against agreements among competitors on price would condemn some agreements, such as the blanket licensing agreements in *Broadcast Music*, that have the potential to promote competition. The fact that a rule forbids conduct that may do some good and that may sometimes even do more good than harm is not a conclusive argument against it.[168] When the rule is judicially formulated, that fact tends to invite some tinkering. For a generation after the *Socony* decision in 1940, the Court refused to condone any tinkering with this particular rule. With the decision in *Broadcast Music*, that era ended.

What the cases clearly contemplate is reform, not repeal. "Horizontal price-fixing and output limitation," the Court observed in *NCAA*, "are ordinarily [unlawful] under an 'illegal *per se*' approach because the probability that these practices are anticompetitive is so high."[169] In a footnote the Court continued: "[w]hile judicial inexperience with a particular arrangement counsels against extending the reach of *per se* rules, . . . the likelihood that horizontal price and output restrictions are anticompetitive is generally sufficient to justify application of the *per se* rule without [further] inquiry. . . ."[170]

The problem, then, is to define those classes of price-fixing agreements that qualify for exceptional treatment. In the case of conventional or "straight" price-fixing agreements—agreements on price unaccompanied by any agreement to collaborate in other potentially procompetitive activity—there is a powerful argument for an absolute prohibition, regardless of purpose or effect. Nothing in the Court's decisions suggests any softening of attitude toward price-fixing of this kind. It is where the agreement on price functions as part of a larger potentially procompetitive undertaking that serious questions about per se illegality arise.

1. Conventional Price-Fixing.—"[I]n characterizing . . . conduct under the *per se* rule," the Court noted in *Broadcast Music*, "our inquiry must focus on . . . whether the practice . . . appears to be one that

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[168]"The per se rule condemns whole categories of practices even though some practices in these categories are beneficial. The Court permits such overbreadth because all *rules* are imprecise. One cannot have the savings of decision by rule without accepting the costs of mistakes." Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 14-15 (1984) (footnotes omitted).

[169]468 U.S. at 100.

[170]*Id.* at n.21. Compare Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752 (1984), in which the Court affirmed two lower-court decisions holding the defendant liable for violation of the per se rule against resale price maintenance, expressly declining the invitation of the Solicitor General and others (*see id.* at 1469 n.7) to reject the rule as unsound.

would always or almost always tend to restrict competition and decrease output . . . ."[171] Per se condemnation of a practice that may promote competition is appropriate, the Court has recently observed, "where the likelihood of anticompetitive conduct is so great as to render unjustified the costs of determining whether the particular case at bar" involves a reasonable restraint.[172]

On these tests, conventional price-fixing fares badly.[173] Perhaps if the rule of reason were the controlling rule, some firms with little or no collective market power would fix prices solely to reduce uncertainty and lower costs.[174] To distinguish these agreements from agreements of the pernicious kind, the courts would have to define markets and attempt to measure collective market power in every conventional price-fixing case.[175] It seems highly unlikely that the economies from such agreements would be worth pursuing at that price.[176] In cases involving firms with

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[171]441 U.S. at 19-20 (footnote omitted).

[172]Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 15-16 n.25 (1984).

[173]For more thorough statements of the arguments summarized here, see R. Bork, *supra* note 22, at 263-69; F. Scherer, Industrial Structure and Economic Performance 438-40 (1970); L. Sullivan, *supra* note 134, § 67; Rahl, *Price Competition and the Price Fixing Rule—Preface and Perspective*, 57 Nw. U.L. Rev. 389, 396-400 (1980); Comment, *supra* note 7, at 864-68.

[174]*See* P. Areeda, Antitrust Analysis—Problems, Text, Cases ¶ 307 (3d ed. 1981); Dewey, *Information, Entry and Welfare: The Case for Collusion*, 69 Am. Econ. Rev. 587 (1979); Easterbrook, *supra* note 22, at 901 n.45.

[175]As Professor Sullivan has noted:

> [B]y putting aside [in *Socony*] the question whether defendants possessed or had acquired through the concerted agreements sufficient market power to impose prices higher than competition would yield, the Court vastly simplified cartel litigation. If power had to be proved, virtually all of the structural and behavioral evidence which is canvassed in a monopoly case could be brought to bear . . . . A court would in the end be forced to delve nearly as fully into the power issue as in a monopoly case.

L. Sullivan, *supra* note 134, § 67, at 186.

[176]*See* Easterbrook, *supra* note 22, at 901; *see also* W. Liebeler, *supra* note 90, at 29-31.

It has been argued that agreements fixing *maximum* prices are distinguishable in this regard from other forms of price fixing, and should be judged under the rule of reason. *See, e.g.*, Easterbrook, *supra* note 22. In *Maricopa*, the Court declined to recognize any distinction:

> Our decisions . . . place horizontal agreements to fix maximum prices on the same legal—even if not economic—footing as agreements to fix minimum or uniform prices. The *per se* rule "is grounded on faith in price competition as a market force [and not] on a policy of low selling prices at the price of eliminating competition." . . . Such a restraint . . . may discourage entry into the market and may deter experimentation and new developments by individual entrepreneurs. It may be a masquerade for an agreement to fix uniform prices, or it may in the future take on that character.

457 U.S. at 348 (footnote omitted). *See generally* L. Sullivan, *supra* note 134, § 78.

substantial power, harm to consumers in the form of higher prices and reduced output would be virtually guaranteed. Benefits typically would be conjectural and difficult to quantify.[177] Defendants in such circumstances would find it hard to satisfy a conscientious court that the economic interests of consumers in competition would not be better served by some lesser restraint or by no restraint at all. In many instances, the suspicion that the firms had entered into the agreement primarily "to make all the money possible"[178] at the consumers' expense, with procompetitive purposes secondary at best, would be impossible to dispel.

Where the parties did succeed in dispelling that suspicion, and established that their fixed prices were reasonable in light of the justification advanced for the price-fixing, there would be a further consideration. As the Court noted long ago, "[t]he power to fix prices, whether reasonably exercised or not, involves [the] power . . . to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow."[179] To sustain the agreement, the court would have to find that the potential benefits from the restraint were large enough to justify assuming a burden of continuing supervision.

The prospect of a regime of price-fixing agreements throughout the economy, administered by courts with the aid of enforcement authorities on a cumbersome variation of the public-utility model, is not attractive. It is small wonder then that ever since the rate-bureau cases of the 1890's, the Court has consistently held in straight price-fixing cases that this is not what the Congress that passed the Sherman Act had in mind.[180]

Reinforcing these arguments for an unequivocal prohibition against straight price-fixing is the deterrent value of a clear, simple rule backed by the credible threat of severe sanctions. Although this aspect is often overlooked in the cases, its importance becomes obvious once the manner of the rule's use is analyzed.

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[177]A classic illustration is the defendants' argument in the rate-bureau cases that their agreement was necessary to prevent "ruinous" or "destructive" competition, which if left unchecked would extinguish otherwise viable railroads one by one, to the detriment of all but the survivor(s). *See* United States v. Joint-Traffic Ass'n, 171 U.S. 505, 576 (1898); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 329-30, 338 (1897).

[178]*See* United States v. American Column & Lumber Co., 257 U.S. 377, 399 (1921).

[179]United States v. Trenton Potteries Co., 273 U.S. 392, 397 (1927).

[180]*See* cases cited *supra* notes 2 & 7. *Chicago Board of Trade* and *Appalachian Coals*, *see supra* note 13, are not to the contrary; neither dealt with conventional price-fixing. *Chicago Board of Trade* involved a commodity exchange rule regulating the price of grain in isolated sales occurring after trading hours; there was no agreement among competing sellers on the price of what they sold. 246 U.S. at 237. In *Appalachian Coals*, the competing coal producers' agreement on the price of sale accompanied an agreement to collaborate on matters other than price—i.e., the formation of a joint selling agency. 288 U.S. at 357-58.

As a deterrent to unreasonably anticompetitive activity, the rule of reason has serious inadequacies. The risk of criminal sanctions for its violation is virtually nil. Though the constitutionality of criminal proceedings under the rule has been upheld, the leading case[181] on the issue is old, and doubts have been expressed that the issue would be resolved the same way today.[182] As a practical matter, the question is all but moot, since the government, in the exercise of its discretion, rarely prosecutes rule-of-reason violations as crimes. On the civil side, the risk of treble damages is attenuated by several factors. Rule-of-reason litigation tends to be complex and expensive. Despite the fact that the rule has been in existence since 1911, in most contexts what the plaintiff must prove in order to prevail is still far from clear. Courts frequently hold that market definition—a miserable process which is often both costly and inconclusive—is an essential aspect of proof.[183] The prevailing impression at the bar is that plaintiffs lose most rule-of-reason cases[184]—if not at trial, then on appeal, in part because the long and involved proceedings at trial provide so much opportunity for error. These factors combine to discourage private litigation under the rule of reason and to encourage settlement on modest terms of suits that are actually brought.

From the standpoint of deterrence, the general rule of per se illegality for agreements among competitors to fix prices is everything that the rule of reason is not. The threat of criminal sanctions for its violation

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[181]Nash v. United States, 229 U.S. 373 (1913) (Sherman Antitrust Act not unconstitutional on grounds of vagueness as to prohibited activities).

[182]*See, e.g.*, Mercurio, *Antitrust Crimes: Time for Legislative Definition*, 51 Notre Dame L. Rev. 437, 443 (1976). Others have suggested that *Nash* was not a strong test of the constitutionality of the rule of reason as a rule of criminal liability because the case involved horizontal price-fixing, which by then was a well-established § 1 violation. *See* Baker, *To Indict or Not to Indict: Prosecutorial Discretion in Sherman Act Enforcement*, 63 Cornell L. Rev. 405, 409 n.23 (1978); Note, *Is the Sherman Act Unconstitutionally Vague as a Criminal Statute? A Re-evaluation after* Gypsum, 13 Suffolk U.L. Rev. 1284, 1289 (1979).

[183]*See, e.g.*, Hood v. Tenneco Texas Life Ins. Co., 739 F.2d 1012, 1018 (5th Cir. 1984); L.A. Draper & Son v. Wheelabrator-Frye, Inc., 735 F.2d 414, 422-23 (11th Cir. 1984); Fine v. Berry & Enright Prods., 731 F.2d 1394, 1399 (9th Cir. 1984), *cert. denied*, 468 U.S. 881 (1985); Hayden Publishing Co. v. Cox Broadcasting Corp., 730 F.2d 64, 69-70 (2d Cir. 1984); Computer Place, Inc. v. Hewlett-Packard Co., 607 F. Supp. 822, 831 (N.D. Cal. 1984). In Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 768 (1984), the Supreme Court implied that an inquiry into market power is essential in every rule-of-reason case. More recently, however, in FTC v. Indiana Fed'n of Dentists, 106 S. Ct. 2009, 2018-19 (1986), the Court appeared to hold that detailed market definition in rule-of-reason cases is not invariably required.

[184]A prominent antitrust attorney has characterized the rule of reason as "a euphemism for an endless economic inquiry resulting in a defense verdict." Blecher, Schwinn—*An Example of a Genuine Commitment to Antitrust Law*, 44 Antitrust L.J. 550, 553 (1975).

is real, and the potential criminal sanctions are severe.[185] The rule can scarcely be said to be unconstitutionally vague.[186] Its simplicity shortens trial in cases actually brought, thus enabling the government to prosecute more cases. It also increases the predictability of the result in any given case. In cases that do not terminate in pleas of guilty, convictions after trial are relatively frequent. Where the elements of a criminal violation are proven,[187] neither the trier of fact nor the judge imposing sentence need be concerned very often that the defendant honestly did not know of the rule or misunderstood it. The per se rule's deterrent effect is also enhanced by an increased risk of treble damages, particularly in suits filed in the wake of criminal prosecutions by private plaintiffs hoping to capitalize on the government's success.[188]

"[W]ithout doubt," Judge Bork has written, "thousands of cartels have been made less effective and other thousands have never been broached because of the overhanging threat" of the per se rules that forbid competitors to fix prices or divide markets.[189] Nothing in the Court's recent decisions implies any tolerance for conventional price-fixing. The agreements on price in these cases have not been conventional; rather, they have been accompanied by potentially procompetitive collaboration in production or distribution or both.

2. Price-Fixing Accompanied by Potentially Procompetitive Collaboration.—As Justice White noted in *Broadcast Music*, "Mergers . . .

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[185]Section 1 of the Sherman Act was amended in 1974 by the Antitrust Procedures and Penalties Act, Pub. L. No. 93-528, § 3, 88 Stat. 1706, 1708. As amended, it provides that every violator "shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court." 15 U.S.C. § 1 (1982).

[186]Defendants in criminal cases have argued unsuccessfully that the rule is objectionable for the opposite reason, i.e., that it deprives them of a jury trial on the issue of "reasonableness." *See, e.g.*, United States v. Manufacturers' Ass'n of the Relocatable Bldg. Indus., 462 F.2d 49 (9th Cir. 1972).

[187]To establish a criminal violation of the Sherman Act, it must be shown that the defendant acted either with the purpose of causing anticompetitive effects or with knowledge that anticompetitive effects would probably result. United States v. United States Gypsum Co., 438 U.S. 422, 443-46 (1978). In cases involving horizontal agreements on price, courts have held that the requisite intent may be inferred from the fact of entry into the agreement. *See, e.g.*, United States v. Foley, 598 F.2d 1323, 1331 (4th Cir.), *cert. denied*, 444 U.S. 1043 (1979); United States v. Brighton Bldg. & Maintenance Co., 598 F.2d 1101 (7th Cir.), *cert. denied*, 444 U.S. 840 (1979). *See generally* Conway, *The Per Se Rule and* Gypsum: *Presuming the Element of Intent*, 10 Mem. St. U.L. Rev. 485, 492-97 (1980), and cases cited; Garvey, *The Sherman Act and the Vicious Will: Developing Standards for Criminal Intent in Sherman Act Prosecutions*, 29 Cath. U.L. Rev. 389, 396-400 (1980).

[188]*See* R. Posner & F. Easterbrook, *supra* note 140, at 151-52.

[189]R. Bork, *supra* note 22, at 263.

eliminate . . . price competition, but they are not *per se* illegal, and many of them withstand attack under any existing antitrust standard."[190] It is generally understood that restraints on competition that are "ancillary" to the formation of partnerships among competitors are defensible under the rule of reason.[191]

The critical difference, from the antitrust standpoint, between straight price-fixing on the one hand and horizontal mergers and partnerships on the other is that the latter are far more likely to be entered into for procompetitive or competitively neutral purposes by firms with little or no market power. Applying a per se rule to such arrangements would condemn not only monopolistic mergers, which the Congress that passed the Sherman Act clearly intended to forbid,[192] but also a great many "combinations in aid of production where there is free and fair competition,"[193] which it clearly wished not to impede.[194]

Like horizontal mergers and partnerships, some forms of horizontal price-fixing involve potentially procompetitive collaboration on matters other than price, such as production or distribution. *Broadcast Music*, *Maricopa*, and *NCAA* all dealt with this type of price-fixing, involving agreements quite different from simple cartels. Arguably, at least, a refusal to recognize any distinctions here among horizontal price-fixing agreements would constitute exactly the kind of "formalistic line drawing" that the Court foreswore in *Sylvania*.[195]

After *Broadcast Music* and *NCAA*, the question is not whether exceptions to the general prohibition against agreements among competitors on price will be recognized, but rather when. Potentially procompetitive collaboration among competitors is to be encouraged, within limits, even if it involves agreement on prices. The task is to define those limits, in terms sufficiently clear that exceptions to the general prohibition do not swallow the rule or significantly impair its effectiveness as a deterrent to "plainly anticompetitive" price-fixing.

It has been suggested, in the wake of *Sylvania* and *Broadcast Music*, that no practice should be held unlawful per se if it has the potential to create significant efficiencies.[196] Recast in terms of *procompetitive* efficiencies, that suggestion would reflect fairly closely the spirit of Justice

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[190] 441 U.S. at 23.

[191] *See* R. Bork, *supra* note 22, at 264-67; *cf.* Louis, *Restraints Ancillary to Joint Ventures and Licensing Agreements: Do* Sealy *and* Topco *Logically Survive* Sylvania *and* Broadcast Music?, 66 Va. L. Rev. 879, 881-82, 902-05 (1980).

[192] *See supra* note 161.

[193] 21 Cong. Rec. 2457 (1890) (remarks of Senator Sherman).

[194] *See supra* text accompanying note 160.

[195] 433 U.S. at 58-59; *see Maricopa*, 457 U.S. at 362 (Powell, J., dissenting).

[196] Easterbrook, *supra* note 22, at 901; *see also* W. Liebeler, *supra* note 90, at 32.

Powell's dissent in *Maricopa*.[197] The difficulty with the suggestion, as applied to horizontal agreements fixing prices, lies in the vagueness of the term "significant." It seems clear that in almost any case in which the exception was claimed, the outcome would depend greatly on the court's ad hoc evaluation of expert testimony about "significance." The weight to be assigned to conflicting opinions on the nature and extent of any efficiencies attributable to the arrangement, as well as opinions on the ultimate issue, would have to be assessed. The result would be a thoroughly ambiguous exception to a rule that presently serves the purposes of the law in large part because of the credible threat of criminal sanctions for its violation. Whether such a rule would pass constitutional muster as a rule of criminal liability is open to question. Whatever the answer, the consensus at least in the past has been that in any case involving legitimate uncertainty as to whether specific conduct is forbidden by the Sherman Act, criminal prosecution is inappropriate.[198] The effect of recognizing an exception to the general prohibition for agreements with "significant" procompetitive efficiencies would be to enlarge the realm of legitimate uncertainty to the point that the rule's utility as a rule of criminal law and a deterrent to unreasonably anticompetitive activity would be seriously undermined.

When the problem is viewed in that light, a much simpler solution suggests itself: straight price-fixing should be unlawful per se; price-fixing accompanied by collaboration on matters other than price should not. Such a rule would be clear in most of its applications and would encourage procompetitive collaboration. Unfortunately, however, it would be far too permissive. It would exempt from per se condemnation agreements that are indistinguishable on the merits from straight price-fixing—agreements in which the price-fixing and the collaboration are wholly independent of one another in practical terms.[199] It would also make the per se rule ridiculously easy to evade.[200] Nothing in the Court's decisions suggests any disposition to relax the rule this far.

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[197]*See supra* text accompanying notes 99-102 and 107-09.

[198]*See, e.g.*, President's Commission on Law Enforcement and Administration of Justice, Task Force Report: Crime and Its Impact — An Assessment 110 (1967); Report of the Attorney General's National Committee to Study the Antitrust Laws 349-51 (1955) [hereinafter Attorney General's Committee Report]; Baker, *supra* note 182, at 412-14.

[199]Consider, for example, an agreement among local dry-cleaning firms to buy chemicals jointly in order to avail themselves of manufacturers' bulk discounts, accompanied by an agreement to fix the price of dry-cleaning services. The joint purchasing agreement might be procompetitive in that it might reduce the firms' costs and enable them to reduce prices. The price-fixing agreement would add nothing. No purpose would be served by exempting the price-fixing agreement in such a case from the operation of the per se rule.

[200]All that would be necessary would be to attach some wholly collateral potentially procompetitive agreement to the agreement on price. *See, e.g.*, the joint undertaking described *supra* note 199.

To qualify for an exception, therefore, the agreement fixing prices must do more than "accompany" procompetitive collaboration; it must promote or facilitate it in some way. The price-fixing agreement must somehow contribute to the success of the collaboration.

The recent decisions are in full accord with that proposition. Each involved an agreement on price that performed an essential function in a larger potentially procompetitive scheme. In *Broadcast Music*, the competing copyright owners' agreement on price "accompanie[d] the integration of sales, monitoring, and enforcement against unauthorized copyright use;"[201] it enabled the copyright owners to offer an attractive product, a blanket copyright license, in competition with individual licenses.[202] The agreement on price was a "necessary consequence" of the procompetitive collaboration; without it, blanket licenses could not be sold.[203] In *NCAA*, as the Court noted, the defendant's rules and regulations "play[ed] a vital role in enabling college football to preserve its character, and as a result enable[d] a product to be marketed which might otherwise be unavailable."[204] The sale of college football television rights in exclusive package form allowed the NCAA members to extract commitments from the networks that resulted in a wider distribution of revenues among NCAA member schools, and potentially in a more competitive product in the market for televised entertainment.[205] Once again, if package licenses were to be sold, there had to be an agreement among competitors on the price. *Maricopa* involved cooperation by competing physicians in the provision of an attractive form of health insurance that apparently could not be provided without a procedure for setting maximum fees. The physicians' practice of developing maximum fee schedules collectively and then submitting them to insurers performed that essential function.[206]

An exception to the general prohibition against horizontal price-fixing for agreements on price that perform an essential function in a larger procompetitive undertaking promotes the interest of consumers in competition without seriously threatening the enforceability of the general prohibition as a rule of criminal law and a deterrent to price-fixing in its most pernicious forms. It is consistent with the law's tolerance in general for horizontal mergers and partnerships and with the long-standing doctrine that restraints ancillary to an agreement with a lawful main purpose are to be judged under the rule of reason, not a per se rule.[207]

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[201] 441 U.S. at 20.
[202] *Id.* at 21-23; *see supra* text accompanying notes 78-80.
[203] 441 U.S. at 21.
[204] 468 U.S. at 102.
[205] *See id.* at 94, 117, and *supra* text accompanying notes 116-17.
[206] 457 U.S. at 339-41, 352; *see supra* text accompanying notes 85-86, 90.
[207] *See Professional Engineers*, 435 U.S. at 688-89; United States v. Addyston Pipe

The exception as formulated leaves two important questions to be resolved. The first concerns the use of price-fixing by competitors for the purpose of raising prices, in order to finance potentially procompetitive collaboration. The second concerns the ultimate disposition in *Maricopa*.

If price-fixing that performs an essential function in a larger procompetitive scheme is ordinarily spared from per se condemnation, what about price-fixing that enables competitors to finance joint procompetitive activity which they otherwise would not undertake? The Court's decisions do not directly address this question. Recognition of a defense on this ground would probably stimulate some joint procompetitive activity. It would almost certainly be unwise, however, for two reasons. First, recognition of such a defense would encourage agreements on price by firms with collective market power. (Firms raising the defense would be conceding, in effect, that collectively they have the power to raise prices profitably by fixing them.) This type of price-fixing, defended on this ground, would confront the courts with all of the intractable problems involved in straight price-fixing—the power to charge unreasonable as well as reasonable prices, the burden of continuing supervision, etc.[208] Second, recognition of the defense, like recognition of a general defense for agreements with "significant" procompetitive potential, would seriously cloud the question of per se illegality in a great many cases. An agreement among pipe manufacturers to rig bids on municipal contracts for cast-iron pipe would be transformed from "clearly unlawful"[209] to "potentially defensible" by the addition of an agreement to conduct joint research into new product development. Uniform price-fixing by the makers of eighty-two percent of the vitreous pottery bathroom fixtures sold in the United States, plainly unlawful when standing alone,[210] would shift into the twilight zone if the firms simultaneously agreed to mount a joint national campaign to inform consumers of the advantages of vitreous pottery in the home. Whether the agreement on price really was essential to the collaboration would be an issue in every case. The result would be the creation of a large gray area, which firms with collective market power would have every incentive to exploit.

All things considered, price-fixing that accompanies potentially procompetitive collaboration should be exempt from per se condemnation only when it performs some essential function in that collaboration *other than* raising prices. That would be entirely consistent with the recent

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and Steel Co., 85 F. 271, 282-83 (6th Cir. 1898), *modified*, 175 U.S. 211 (1899); Louis, *supra* note 191.

[208] *See supra* text accompanying notes 177-79.

[209] *See* Addyston Pipe & Steel Co., 85 F. at 282-83.

[210] United States v. Trenton Potteries Co., 273 U.S. 392 (1927).

decisions. The parties to the price-fixing in these cases defended the practice as an incident of the *type* of collaboration in which they were engaged; they did not defend it, nor did the Court condone it, on the ground that it enabled them to charge more for the product and benefit the public thereby.[211]

There, perhaps, the analysis would end, but for *Maricopa*. In *Maricopa*, the physicians' agreements on maximum prices served the useful function of capping fees in a cooperative insurance scheme, which had to be done, apparently, to make the scheme work. What, then, distinguished that case from *Broadcast Music* and *NCAA* so as to justify the entry of summary judgment for the plaintiff on the issue of per se illegality?

It has been suggested that the answer is that *Broadcast Music* and *Maricopa* are not genuinely distinguishable and that *Maricopa* was wrongly decided.[212] A contrary view, which has much to recommend it, is that *Maricopa* represents a sound ad hoc application of the general criteria for per se illegality stated by the Court in *Sylvania* and restated in one form or another in virtually every subsequent per se decision:

> *Per se* rules thus require the Court to make broad generalizations about the social utility of particular commercial practices. The probability that anticompetitive consequences will result from a practice and the severity of those consequences must be balanced against its procompetitive consequences. Cases that do not fit the generalization may arise, but a *per se* rule reflects the judgment that such cases are not sufficiently common or important to justify the time or expense necessary to identify them.[213]

Because the agreement on price in *Maricopa* facilitated procompetitive collaboration among the doctors and insurers in the way it did, it could not appropriately be condemned per se without further inquiry. On

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[211]In *Broadcast Music*, the parties to the price-fixing apparently had substantial collective market power. *See* 441 U.S. at 5; *see supra* text accompanying note 62; Cirace, CBS v. ASCAP: *An Economic Analysis of a Political Problem*, 47 Fordham L. Rev. 277, 281 (1978). In *NCAA*, they clearly did. 468 U.S. at 111-12. In *NCAA*, the only case in which the Court reached the merits under the rule of reason, the Court held that the fact that the defendants controlled the sale of a product with no close substitutes weighed against a finding in their favor. *Id.* at 115. At no point in these opinions did the Court intimate that the exercise of market power through price-fixing could be defended on the ground that the parties had put their monopoly profits to beneficial use.

[212]*See, e.g.*, W. Liebeler, *supra* note 90, at 31-32.

[213]*Sylvania*, 433 U.S. at 50 n.16; *see* Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co., 472 U.S. 284, 289-90 (1985); *NCAA*, 468 U.S. at 103-04; Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 15-16 & n.25 (1984); *Maricopa*, 457 U.S. at 343-45 & n.16; Catalano Inc. v. Target Sales, Inc., 446 U.S. 643, 648-49 (1980); *Broadcast Music*, 441 U.S. at 19-20; *Professional Engineers*, 435 U.S. at 692.

further inquiry, the probability that anticompetitive consequences would result from the practice was high.[214] Its function could be performed another way at significantly less competitive risk: The maximum fee schedules could be developed in the first instance by the insurers, who would have derived no benefit from setting fees above the then prevailing levels. The alternative procedure would have its costs; it would be less efficient. The question, then, came down to whether there was "reason to believe," on the record before the Court, "that any savings that might accrue from this arrangement would be sufficiently great to affect the competitiveness of these kinds of insurance plans" or otherwise to justify the competitive risks inherent in the practice.[215] The Court concluded that there was none. That conclusion, it appears, was well founded. The only economies possible from the arrangement were those that might result from having the doctors canvassed concerning fees by their own foundations rather than by the insurers. Had the Court decided the per se issue the other way, the plaintiff in *Maricopa* (and subsequent plaintiffs in similar cases) would have faced lengthy and difficult burdens of proof on the issues of power and effect, simply to preserve very small gains from a practice with very large anticompetitive potential.

Given the nature of the inquiry under the *Sylvania* test and the uncertainty of the outcome, even where the result is per se condemnation, considerations of fairness militate against the imposition of criminal sanctions. In general, then, horizontal agreements on price that accompany potentially procompetitive collaboration and perform some essential function other than raising prices are inappropriate for felony prosecution and punishment. There are, arguably, two exceptions: agreements entered into for the primary purpose of raising prices above competitive levels, where the agreement to collaborate on something potentially procompetitive is a pretext;[216] and practices that have previously been authoritatively held (as the maximum fee arrangements in *Maricopa* have now been held) to be unlawful per se.[217]

IV. Conclusion

For many years it has served the law's purpose to state flatly that "price-fixing" is unlawful wherever found, without precisely defining

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[214]*See supra* text accompanying notes 103-05.

[215]457 U.S. at 352-54; *see supra* note 98.

[216]*See* Attorney General's Committee Report, *supra* note 198, at 350-51 (criminal prosecution appropriate where there is proof of a "specific intent to restrain trade"); *cf.* United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 220 (1940) (defendants sought "[t]he elimination of so-called competitive evils . . . primarily for its effect on the price structures;" criminal convictions for "price-fixing" affirmed).

[217]*See, e.g.*, President's Commission on Law Enforcement and the Administration of Justice, Task Force Report: Crime and Its Impact — An Assessment 110 (1967)

the term. Under this rubric, a great many horizontal agreements on price have been condemned without regard to purpose, power, or effect. Agreements among competitors fixing the prices of their products would appear to be "price-fixing," if anything is. Nevertheless—because old cases sustaining such agreements have never been squarely overruled, because lower courts have occasionally recognized exceptions without being chastised, because even statutes allow for interpretation contrary to their "plain meaning" where a literal interpretation would produce an anomalous result, because antitrust law lends itself so poorly to absolutes—there has always been some reluctance to declare that the fixing of prices by competitors in combination offends section 1 of the Sherman Act no matter what form it takes. Now it is clear that it does not.

The decisions in *Broadcast Music*, *Maricopa*, and *NCAA* all proceed from the same basic premise: when competitors combine to fix the price of what they sell, the law's first concern is to protect the economic interests of consumers in competition. Ordinarily the competitive risks of such combinations sufficiently outweigh the competitive benefits to justify a flat prohibition, backed by severe sanctions. The exceptional cases—the cases in which the Court has recognized exceptions—are those in which the competitors' agreement on price accompanies potentially procompetitive collaboration on matters other than price and performs an essential function in that collaboration other than raising prices. Ordinarily, the cases suggest, where those conditions are met, as they were in *Broadcast Music* and *NCAA*, the applicable standard under section 1 is the rule of reason. Such practices are unlawful per se only if, as in *Maricopa*, further inquiry discloses that the competitive benefits are so slight in relation to the competitive risks that recognition of an exception to the general rule of per se illegality for horizontal price-fixing agreements would do more harm than good.

These principles have potentially wider application. The per se rule against "price-fixing" has been applied to a variety of horizontal restraints on price competition other than agreements among competitors on price.[218] *Catalano*[219] is the Court's most recent decision in this line. Like most of the agreements in these cases, the arrangement struck down in *Catalano*—a compact among wholesalers to discontinue the extension of trade credit to retailers—involved no agreement to engage in procompetitive collaboration on matters other than price. Arguably, at least,

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(criminal prosecution appropriate in antitrust cases where "it appears that the defendants knew they were violating the law or were acting with flagrant disregard for the legality of their conduct . . . .").

[218] *See supra* note 4.

[219] 446 U.S. 643 (1980); *see supra* text accompanying notes 81-83.

when a horizontal price restraint of any type performs an essential function (other than raising prices) in a larger procompetitive scheme, on the principles of *Broadcast Music*, *Maricopa*, and *NCAA*, it ought not be held unlawful per se without further inquiry into the availability of less restrictive alternatives and a comparison of the risks and benefits.

Horizontal restraints on price and output, the Court affirmed in *NCAA*, are "the paradigmatic examples of restraints of trade that the Sherman Act was intended to prohibit."[220] So long as protection of the economic interests of consumers in competition remains the primary objective, a per se prohibition against agreements among competitors on the price of what they sell is sound as a general rule. The problem is to frame the exceptions so as to encourage procompetitive collaboration among competitors, without imposing an untenable burden of supervision upon the courts or blunting the force of the per se rule as a deterrent to pernicious price-fixing agreements. Though the Court's decisions and opinions in *Broadcast Music*, *Maricopa*, and *NCAA* do not supply a complete solution, they do point the way.

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[220] 468 U.S. at 107-08.

Speech

Presenting a State Constitutional Argument: Comment on Theory and Technique*

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I. INTRODUCTION

Your invitation to join you as a Distinguished Jurist-in-Residence affords me an opportunity to make some small contribution towards repaying the large constitutional debt we in the Pacific Northwest owe the people of Indiana. Few citizens of Indiana realize that both Washington and Oregon modeled their bills of rights on the Indiana Constitution of 1851.[1] Indiana's charter, adopted initially in 1816, has antecedents dating back to revolutionary era state constitutions.[2] Each of these state constitutions provides a rich source of civil liberty pro-

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*This Article is an adaptation of an address given by Justice Utter as Distinguished Jurist-in-Residence at the Indiana University School of Law—Indianapolis on February 10, 1987.

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[1]Washington's Declaration of Rights, adopted in 1859, borrowed heavily from the Indiana Constitution. *See* THE JOURNAL OF THE WASHINGTON STATE CONSTITUTIONAL CONVENTION 1889, at 496 n.12 (free expression), 500 n.19 (no religious test for office), 511 n.37 (rights of criminally accused), 501 n.20 (equal privileges) (B. Rosenow ed. 1962) [hereinafter WASHINGTON JOURNAL]. Oregon adopted its Bill of Rights in 1859, copying its provisions almost verbatim from Indiana. THE OREGON CONSTITUTION AND PROCEEDINGS AND DEBATE OF THE CONSTITUTIONAL CONVENTION OF 1857, at 302, 478-79 (Salem, Or. 1926) [hereinafter OREGON PROCEEDINGS]. Delegates to the Oregon convention considered the Indiana Constitution to be the best of all the state constitutions in existence at that time. *Id.* at 101 (statement of delegate Delazon Smith).

In choosing the Indiana Constitution as a model, rather than the federal Bill of Rights, Oregon and Washington continued a long tradition of states taking their bills of rights from preexisting state constitutions. Linde, *First Things First: Rediscovering the States' Bills of Rights*, 9 U. BALT. L. REV. 379, 381 (1980).

[2]Both the 1816 and 1851 bills of rights derived many of their constitutional guarantees from the Kentucky Constitution of 1792 and the Ohio Constitution of 1803. Twomley, *The Indiana Bill of Rights*, 20 IND. L. J. 211, 212-13 (1945). Ohio had based its rights provisions on guarantees found in the original thirteen written constitutions, each of which predated the federal Bill of Rights. Linde, *supra* note 1, at 381. *See also* Carson, *"Last Things Last": A Methodological Approach to Legal Argument in State Courts*, 19 WILLIAMETTE L. REV. 641, 655 (1983).

tections. However, despite borrowing from earlier state charters, each state constitution reflects, in its wording and protections, the unique concerns and history of its state. For example, as a rule, in the area of religious freedoms, state constitutions differ significantly from the free exercise and establishment provisions of the first amendment.[3] The Indiana Bill of Rights makes the point vividly with six separate clauses dealing with freedom of religion,[4] reflecting an intention to have an absolute separation of state and church in their respective fields.[5]

Framers of the various state constitutions intended their charters as the primary devices to protect individual rights. The federal Bill of Rights was perceived as a secondary layer of protection, applying only against the federal government.[6] Nevertheless, we have witnessed in our lifetimes a complete reversal in roles due to the United States Supreme Court's application of much of the federal Bill of Rights against the states through selective incorporation into the fourteenth amendment's due process clause.[7] As federal constitutional law came to dominate the individual rights field, state constitutional rights litigation all but disappeared. Out of the countless decisions reached by state courts during the 1950's and 60's, only ten state court decisions relied on state constitutional provisions to protect individual rights.[8]

In recent years various state supreme courts across the nation have begun to rediscover the broad, and often unique, protections their state constitutions afford. Relying on the rich constitutional heritage it inherited from Indiana, Oregon has become the nation's second leading court in state constitutional rights decisions.[9] In one case, the Oregon Supreme

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[3]Collins, *Bills & Declarations of Rights Digest*, in The American Bench 2483, 2496 (1985).

[4]Ind. Const. art. 1, § 2 (natural right to worship), § 3 (freedom of religious opinions and conscience), § 4 (freedom of religion), § 5 (no religious test for office), § 6 (no public funds), § 7 (witness competent regardless of religious opinions).

[5]Twomley, *supra* note 2, at 223 (citing Op. Att'y Gen. of Ind. 358 (1934)).

[6]Utter, *Freedom and Diversity in a Federal System: Perspectives on State Constitutions and the Washington Declaration of Rights*, 7 U. Puget Sound L. Rev. 491, 497 (1984). The historic role of state judges included serving as "the primary defenders of civil liberties and equal rights." Wright, *In Praise of State Courts: Confessions of a Federal Judge*, 11 Hastings Const. L.Q. 165, 188 (1984).

[7]*See, e.g.*, Duncan v. Louisiana, 391 U.S. 145 (1968) (sixth amendment right to a jury); Malloy v. Hogan, 378 U.S. 1 (1964) (privilege against compelled self-incrimination); Mapp v. Ohio, 367 U.S. 643 (1961) (fourth amendment exclusionary rule); NAACP v. Alabama, 357 U.S. 229 (1958) (freedom of association); Wolf v. Colorado, 338 U.S. 25 (1949) (fourth amendment but not the exclusionary rule); Everson v. Board of Educ., 330 U.S. 1 (1947) (establishment of religion clause); Cantwell v. Connecticut, 310 U.S. 296 (1940) (free exercise of religion clause); Gitlow v. New York, 268 U.S. 652 (1925) (freedom of speech and press).

[8]Collins, Galie & Kincaid, *State High Courts, State Constitutions, and Individual Rights Litigation Since 1980: A Judicial Survey*, 16 Publius 141, 142 Table 1 (1986).

[9]*Id.* at 161 (measured in terms of actual number of decisions rendered based on state constitution).

Court held that punitive damages were unavailable in a libel suit,[10] basing its decision on the interplay between the free speech guarantee and the constitutional guarantee of a remedy for injuries to a person's reputation,[11] provisions copied directly from Indiana.[12] In Washington, we found that the language of our state free speech provision, which is nearly identical to that of Indiana,[13] prohibits prior restraints on protected speech under any circumstances.[14]

State constitution based decisions do not always result in rights broader than those guaranteed by the federal Constitution. For example, suppose you were involved in an effort to get an initiative on the ballot in your state. You approach the owners of the largest private shopping mall in your area and request permission to gather signature petitions at the mall. Other mall proprietors in the area have already agreed, but this owner denies your request. Believing such denial to be unconstitutional, you seek the protection of the courts. What result?[15] If you based your claim on the first amendment to the federal Constitution, you would lose on a 12(b)(6) motion; the United States Supreme Court has repeatedly held that due to the state action requirement, the first amendment does not protect free speech activities in private shopping centers.[16] Similar results would occur under the state constitutions of North Carolina,[17] Connecticut,[18] and Michigan.[19] However, the state

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[10]Wheeler v. Green, 286 Or. 99, 593 P.2d 777 (1979) (rejecting federal approach adopted in Gertz v. Robert Welch, Inc., 418 U.S. 323 (1974)).

[11]OR. CONST. art. 1, §§ 8, 10.

[12]IND. CONST. art. 1, §§ 9, 12.

[13]The Washington Declarations of Rights provides that "[e]very person may freely speak, write and publish on all subjects, being responsible for the abuse of that right." WASH. CONST. art. 1, § 5. By comparison, the Indiana Bill of Rights provides that "[n]o law shall be passed, restraining the free interchange of thought and opinion, or restricting the right to speak, write, or print freely, on any subject whatever: but for the abuse of that right, every person shall be responsible." IND. CONST. art. 1, § 9. In Washington, a plurality of the state supreme court has viewed the difference in text as negating a state action requirement under art. 1, § 5. Alderwood Assocs. v. Washington Envtl. Council, 96 Wash. 2d 230, 635 P.2d 108 (1981).

[14]State v. Coe, 101 Wash. 2d 364, 374, 679 P.2d 353, 358 (1984).

[15]For a case with facts similar to these, see Alderwood Assoc. v. Washington Envtl. Council, 96 Wash. 2d 230, 635 P.2d 108 (1981).

[16]*See, e.g.*, Hudgens v. NLRB, 424 U.S. 507 (1976) (no first amendment right to enter private shopping center to advertise strike against employer located in center); Lloyd Corp. v. Tanner, 407 U.S. 551 (1972) (federal first amendment does not prevent shopping center owner from prohibiting handbill distribution); *see also* Pruneyard Shopping Center v. Robins, 447 U.S. 74, 83 (1980) (while federal constitution does not protect free speech in a shopping center, application of California's free expression provision to shopping centers does not violate any federally protected property rights).

[17]State v. Felmet, 303 N.C. 171, 273 S.E.2d 708 (1981) (state constitution does not protect solicitation of petition signatures in private parking lot).

[18]Cologne v. Westfarms, 192 Conn. 48, 469 A.2d 1201 (1984).

[19]Woodland v. Michigan Citizens Lobby, 128 Mich. App. 649, 341 N.W.2d 174 (1983) (state constitution grants no right to petition signature gatherers to solicit in shopping mall).

constitution would protect your right to gather petition signatures at shopping centers located in Washington,[20] California,[21] and Massachusetts.[22] Broader protection, however, is not always the issue. A recent example of a state constitution providing less protection than the federal minimum occurred, ironically, in Oregon. A plurality of the Oregon Supreme Court held that unlike federal law, the Oregon Constitution does not require *Miranda*-style warnings before police officers can interrogate a suspect.[23]

Undoubtedly, a resurgence has occurred in the amount of attention paid to, and the importance of, state constitutions. United States Supreme Court Justice William J. Brennan described this reawakening of state constitutional law as "probably the most important development in constitutional jurisprudence of our time."[24] Yet, despite the notable increase in the serious consideration of state constitutional issues since 1980,[25] the majority of states have a low level of state constitutional rights litigation.[26] Some state courts have virtually no record of reliance on their state constitutions[27] so that large sections of the country, including the Midwest, remain largely unaffected by the growing trend toward development of independent state constitutional jurisprudence.[28]

As we shall see, one of the major reasons for state court reluctance to interpret and to apply state constitutions is the failure of litigators to claim state constitutional errors.[29] Consequently, I urge you to discover

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[20]Alderwood Assocs. v. Washington Envtl. Council, 96 Wash. 2d 230, 635 P.2d 108 (1981) (plurality found state free speech provision has no state action requirement).

[21]Robins v. Pruneyard Shopping Center, 23 Cal. 3d 899, 592 P.2d 341, 153 Cal. Rptr. 854 (1979) (state free speech guarantee requires access to shopping center, but court expressed no opinion on state action requirement), *aff'd*, 447 U.S. 74 (1980).

[22]Batchelder v. Allied Stores Int'l Inc., 388 Mass. 83, 445 N.E.2d 590 (1983) (relying on state's fundamental interest in elections, rather than the state's free expression provision).

[23]State v. Smith, 301 Or. 681, 725 P.2d 894 (1986).

[24]"The Fourteenth Amendment" Address by Justice William J. Brennan, Jr., American Bar Association Section on Individual Rights and Responsibilities, New York University Law School (Aug. 8, 1986).

[25]Collins, Galie & Kincaid, *supra* note 8, at 143-44.

[26]*Id.* at 160-61. A 1982 study identified only fourteen states as having a moderate or better reputation for protecting civil liberties under their state constitutions. Tarr & Porter, *Gender Equality and Judicial Federalism: The Role of State Appellate Courts*, 9 HASTINGS CONST. L.Q. 919, 953-54 app. (1982) (Table A) (Alaska, California, Hawaii, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, Oregon, Pennsylvania, Washington, and Wisconsin). As of 1985, Wisconsin Justice Shirley Abrahamson suggested adding four states for a total of eighteen. Abrahamson, *Criminal Law and State Constitutions: The Emergence of State Constitutional Law*, 63 TEX. L. REV. 1141, 1181 (1985) (Arizona, Mississippi, New Hampshire, and Vermont).

[27]Collins, Galie & Kincaid, *supra* note 8, at 146.

[28]*Id.* at 146 (Table 3) (of 311 actual cases decided since 1950 on independent state constitutional grounds, the Midwest accounted for only 6.8%).

[29]*See infra* note 31.

the richness of the Indiana Constitution. Hopefully, I can provide you with some of the tools necessary to formulate persuasive state constitutional arguments. First, we will review why gaining a working familiarity with your state constitution plays an important role in your future legal career. Next, we will discuss some of the key concepts you need to master, including an understanding of the pivotal effect federalism has on a state judge's constitutional perspective and how various state courts approach state constitutional analysis. Our focus then turns to what factors play the most important roles in framing a state constitutional argument. Finally, we will look at how state courts have interpreted and applied several bill of rights provisions that have analogs in the Indiana Constitution.

II. The Importance of State Constitutional Law to the Practitioner

Given the slower development of state constitutional litigation in the Midwest, you may be asking why you should be concerned with learning about the use of state constitutions. Commentators have identified several reasons, over which you as lawyers will have little control, for a court's failure to examine the state constituton.[30] However, whether you raise the state constitutional issue is within your control, and the failure to squarely raise the issue is cited often as the major reason why state appellate courts do not look to the state constitution.[31] An example will illustrate the point. Under its usual practice, the Maine Supreme Court reviews the state constitution before addressing federal constitutional issues.[32] The 1984 case of *State v. Philbrick*[33] implicated important state constitutional issues.[34] Nevertheless, because of judicial restraint considerations, the Maine court departed from its usual practice and refused to examine the state constitutional issues because the defendant did not argue that his state constitutional rights had been infringed.[35]

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[30]Abrahamson, *supra* note 26, at 1160 (possibilities include judicial oversight and carelessness, constitutional issue not ripe for decision, author of majority opinion not sympathetic to use of state constitution).

[31]Alderwood Assocs. v. Washington Envtl. Council, 96 Wash. 2d 230, 238, 635 P.2d 108, 113 (1982). Almost 80% of the state supreme court justices responding to a recent survey indicated that their court would decline to hear a state constitutional claim if the litigant failed to raise the claim below. Collins, Galie & Kincaid, *supra* note 8, at 154. Justices of the Indiana Supreme Court were among those responding. *Id.* at 142 n.2.

[32]*See generally* Comment, *The Primacy Method of State Constitutional Decision-making: Interpreting the Maine Constitution*, 38 Me. L. Rev. 491 (1986).

[33]481 A.2d 488 (Me. 1984).

[34]*Id.* at 493 n.3.

[35]*Id.* Even where the United States Supreme Court remands and explicitly reminds a state court that it is free to interpret its own constitution, some state courts refuse to

In order to protect your clients, you will have a duty to raise, and effectively develop, state constitutional issues where appropriate. If you intend to practice here in Indiana, you should note that decisions by the Indiana Supreme Court display a willingness to examine the state constitution.[36] Your responsibility to your client will dictate that you take advantage of the court's willingness. If you intend to practice outside Indiana, state supreme court justices across the country have increasingly urged lawyers to base claims for individual protections on state constitutions.[37] The failure to raise state issues could have a serious effect on you personally; various jurists and commentators believe that lawyers "skate on the edge of malpractice" if they fail to argue and adequately brief state constitutional issues in claiming constitutional protections for their clients.[38]

State constitutional law is still in the initial stages of reawakening.[39] I cannot overemphasize the importance of the role you play in the rediscovery of civil liberty protections contained in state constitutions. As Vermont State Supreme Court Justice Thomas L. Hayes has pointed out, "[l]awyers have an unparalleled opportunity to aid in the formulation of a state constitutional jurisprudence that will protect the rights and liberties of our people."[40]

III. Historical and Legal Relationship Between State and Federal Constitutions

To construct a successful state constitutional argument, a lawyer must understand the relationship, both historical and legal, between the state and federal constitutions. Early constitutional history of the United States reveals that while federal law was to be supreme,[41] the framers intended the states' bills of rights to work independently of the federal Constitution.[42] Most of the states had declarations of rights years before the United States Constitution.[43] Somewhat later, the federal Bill of Rights

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address the issue when the parties fail to raise it. *See, e.g.*, White v. State, 521 S.W. 2d 225, 258 (Tex. Crim. App. 1974), *rev'd. per curiam*, 423 U.S. 67 (1975).

[36]*See, e.g.*, Reilly v. Robertson, 266 Ind. 29, 360 N.E.2d 171, *cert. denied*, 434 U.S. 825 (1977) (state court interpretation of a state constitutional provision is an independent judicial act and federal cases have only persuasive force); Sidle v. Majors, 264 Ind. 206, 210, 341 N.E.2d 763, 767 (1976) (interpreting article 1, section 12).

[37]Bamberger, *Boosting Your Case with Your State Constitution*, 72 A.B.A. J. 49, 49 (1986).

[38]Welsh & Collins, *Taking State Constitutions Seriously*, Center Mag., Sept.-Oct. 1981, at 6-12.

[39]Abrahamson, *supra* note 26 at 1186.

[40]State v. Jewett, 146 Vt. 221, 224, 500 A.2d 233, 235 (1985).

[41]U.S. Const. art. VI.

[42]Bamberger, *supra* note 37, at 49.

[43]Utter, *supra* note 6, at 496.

was finally added to the Constitution to meet demands for the same guarantees against federal power as people enjoyed against state governments.[44] During the early years of the republic, some argued that the federal Bill of Rights also limited state authority. However, in the 1833 case of *Barron v. Mayor of Baltimore*,[45] the Supreme Court confirmed that state authority remained unfettered by the federal Bill of Rights, which the Court found served only as a limit on the power of the federal government. Thus, throughout the nineteenth and early twentieth centuries, state constitutional rights guarantees, as interpreted by state courts, served as the primary protection of individual liberty against the government expected to have the most effect on everyday life—the individual states.[46]

During the ascendancy of state constitutional law, state judges were the "primary defenders of civil liberties and of equal rights."[47] State court interpretations of state civil liberty protections often served as models for later Supreme Court interpretations of the federal Constitution. Most notably, state decisions shaped federal law in the areas of judicial review, substantive due process, freedom of speech and religion, eminent domain, the right to bear arms, and the rights of the accused.[48] For example, decades before the United States Supreme Court acted in *Gideon v. Wainwright*,[49] the Indiana Supreme Court held that the state constitutional right to counsel entitled indigent criminal defendants to counsel at state expense.[50]

As the simple agrarian society of the founders metamorphosed into a national, high technology, industrialized society, power naturally shifted from the states to the federal government.[51] As part of this power shift, civil liberties became federalized. Several historical events played a crucial role in this federalization process: the ratification of the fourteenth amendment, selective incorporation of the federal Bill of Rights into the due process clause, and the Warren Court's revolutionary use of the

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[44]*Id.*; Linde, *supra* note 1, at 381; *see also* Mosk, *State Constitutionalism: Both Liberal and Conservative*, 63 Tex. L. Rev. 1081, 1083 (1985).

[45]32 U.S. (7 Pet.) 243, 250 (1833).

[46]The Federalist No. 45 at 319 (J. Madison) (E. Bourne ed. 1937).

[47]Wright, *supra* note 6, at 188.

[48]Utter, *Swimming in the Jaws of the Crocodile: State Court Comment on Federal Constitutional Issues When Disposing of Cases on State Constitutional Grounds*, 63 Tex. L. Rev. 1025, 1030 (1985).

[49]372 U.S. 335 (1963).

[50]Rader v. State, 181 Ind. App. 546, 552, 393 N.E.2d 199, 203 n.3 (1979); Note, *The Indigent Defendant in the State Criminal Proceeding:* Betts v. Brady *Is Interred*, 38 Ind. L.J. 623 (1963); *see also* Campbell v. State, 229 Ind. 198, 203, 96 N.E.2d 876, 878 (1951).

[51]Wisdom, *Foreword: The Ever Whirling Wheels of American Federalism*, 59 Notre Dame L. Rev. 1063, 1078 (1984).

equal protection clause to guarantee equality.[52] Most importantly, however, application of federal guarantees against state authority arose because, despite their role as the primary protector of individual liberty, state courts often did not give serious consideration to civil liberty protections.[53] Take Indiana's free speech provision, article 1, section 9 for instance. During the 1920's, the Indiana Supreme Court had a poor record for protecting the right of free speech.[54] In one case the Indiana court upheld a city ordinance making it unlawful to carry any banner, placard, advertisement, or handbill in any public place.[55] In another case, the court upheld an ordinance prohibiting all picketing.[56] Indiana was by no means alone. Other states also failed to adequately assure freedom of expression.[57] As a result, the United States Supreme Court stepped in, applied the first amendment to state authority,[58] and invalidated both types of ordinances.[59]

Today, much of the federal Bill of Rights has been incorporated into the fourteenth amendment.[60] Because of incorporation and the supremacy clause, Supreme Court interpretations of federal civil liberty guarantees set a minimum level of protection.[61] While state courts must enforce these minimum federal constitutional standards, no one questions a state court's power to construe state provisions as providing broader protection for individual rights.[62] Incorporation of federal guarantees into the fourteenth amendment does not relieve state courts from their primary responsibility for protecting individual rights.[63]

At the very heart of a state court's responsibility you will find the concept of federalism, America's gift to political theory.[64] The framers

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[52]Kurland, *The Supreme Court, 1963 Term-Foreword: "Equal in Origin and Equal in Title to the Legislative and Executive Branches of the Government,"* 78 Harv. L. Rev. 143, 145-62 (1964) (Warren Court worked an "egalitarian revolution"); Mosk, *supra* note 44, at 1084.

[53]*See, e.g.*, Mosk, *The State Courts*, in American Law: The Third Century 213, 216 (B. Schwartz ed. 1976).

[54]Twomley, *supra* note 2, at 223.

[55]Waters v. Indianapolis, 191 Ind. 671, 134 N.E. 482 (1921).

[56]Thomas v. Indianapolis, 195 Ind. 440, 145 N.E. 550 (1924).

[57]*See generally* Simon, *Independent But Inadequate: State Constitutions and Protection of Freedom of Expression*, 33 Kansas L. Rev. 305 (1985).

[58]Gitlow v. New York, 268 U.S. 652 (1925); *see* Simon, *supra* note 57, at 305.

[59]*See, e.g.*, Thornhill v. Alabama, 310 U.S. 88 (1940) (invalidating bans on picketing); Schneider v. New Jersey, 308 U.S. 147 (1939) (invalidating bans on handbill distribution in public places).

[60]See *supra* note 7 and accompanying text.

[61]*See, e.g.*, Pruneyard Shopping Center v. Robins, 447 U.S. 74, 81 (1980); Oregon v. Haas, 420 U.S. 714, 719 n.4 (1975).

[62]*Pruneyard*, 447 U.S. at 81; *Haas*, 420 U.S. at 719.

[63]Utter, *supra* note 6, at 497.

[64]Linde, *E. Pluribus—Constitutional Theory and State Courts*, 18 Ga. L. Rev. 165, 194 (1984).

of the United States Constitution designed a compound American republic, in which the people surrendered power to dual sovereign governments—state and federal.[65] By choosing this "classical model" of federalism,[66] the framers intended to provide double security for the people's individual rights.[67] The dual sovereignty federal structure also provides the people of each state with the opportunity to serve as constitutional laboratories, experimenting with "novel social and economic experiments."[68] The federal nature of our compound republic mandates that state courts determine the scope of a state constitution's liberty protections.[69] When a state court fails to independently evaluate its state constitution, it deprives the people of the double security the nation's founding fathers intended to provide.

Even though state courts have the power to independently interpret their state constitutions, defining the scope of state protections in the face of federally mandated minimum standards can lead to tensions between the federal and state judicial systems.[70] The type of state constitutional provision determines whether such tension exists. Interpretations of state provisions without federal analogs need not take into account federal minimum standards. As a result, such decisions create no tension with federal law. Most often, a state court will look to other state court decisions interpreting analogous state provisions. For example, unlike the federal Constitution, the Indiana Constitution contains a right to a remedy for personal injury.[71] When the Indiana Supreme Court held that automobile guest statutes do not violate that provision, the court had no need to look to federal law. Instead, the court reached its result after an independent analysis, which included reviewing decisions by sister state supreme courts.[72]

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[65]The Federalist No. 51, at 339 (A. Hamilton or J. Madison) (Modern Library ed. 1937).

[66]Comment, *supra* note 32, at 503. Federalism often gets divided into separate concepts. Vertical federalism refers to the general relationship between a state and the federal government. *See* M. Porter & G. Tarr, State Supreme Courts Policymakers in the Federal System xix-xx (1982). Horizontal federalism refers to the general political and legal relations among the states. Comment, *supra* note 32, at 503 n.37.

[67]*See* Comment, *supra* note 32, at 503 n.37.

[68]"It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country . . ." New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting); *see also* Williams v. Florida, 399 U.S. 78, 133 (1970) (Harlan J., concurring).

[69]Utter, *supra* note 6, at 493 (quoting Alderwood Assocs. v. Washington Envtl. Council, 96 Wash. 2d 230, 237-38, 635 P.2d 108, 113 (1981) (citations omitted)).

[70]*See* Comment, *supra* note 32, at 521.

[71]Ind. Const. art. 1, § 12.

[72]Sidle v. Majors, 264 Ind. 206, 211, 341 N.E.2d 763, 767 (1976).

When you intend to raise state provisions that have federal analogs, you should be aware of the tensions created by the supremacy clause and federal minimum standards. There are two types of analogs. Language analogs exist when federal and state provisions have identical or nearly identical text. Substantive analogs occur when federal and state provisions have different text, but provide similar substantive protection.[73] In determining the meaning and scope of state provisions that have either type of federal analog, state courts often refer to federal precedent in their analysis. In so doing they run the risk of Supreme Court review and reversal. In *Michigan v. Long*,[74] the Supreme Court established a presumption of federal review of state decisions that do not "indicate clearly and expressly that the [decision] is alternatively based on bona fide, separate, adequate and independent grounds."[75] Under this approach, the Court will exercise jurisdiction if the state decision interweaves state and federal law excessively or if a state court's reasoning and conclusion appear compelled by federal precedent.[76]

Federal minimums and the potential for Supreme Court review and reversal create tension when state courts determine the scope of state constitutional provisions. Often, this tension manifests itself within a state supreme court over what approach to take in state constitutional interpretation. For example, members of the New Jersey court split over the need to refer to a neutral set of criteria to determine if state provisions provide protections broader than federal minimums.[77] State court decisions that interpret a state provision more broadly often create tension with United States Supreme Court Justices. For example, before retiring, United States Supreme Court Chief Justice Warren E. Burger criticized state court broader-protection-decisions favoring criminal defendants as not being "rational law enforcement."[78] The response this comment generated highlights state-federal tensions, with one state justice characterizing the Chief Justice's approach as exemplifying a Supreme Court policy of unwarranted intrusion into state authority.[79]

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[73]*See infra* notes 160-69 and accompanying text.

[74]463 U.S. 1032 (1983).

[75]*Id.* at 1048. The *Long* approach has reversed the traditional Supreme Court presumption that state courts act independently unless the record establishes differently. *Id.* at 1066 (Stevens, J., dissenting). *See* Utter, *supra* note 48, at 1026 n.2.

[76]*See* Comment, *supra* note 32, at 512 n.56.

[77]*Compare* State v. Hunt, 91 N.J. 338, 364-68, 450 A.2d 952, 965-67 (1982) (Handler, J., concurring) (proposing neutral criteria to justify departure from federal precedent) *with* Right to Choose v. Byrne, 91 N.J. 287, 332-33, 450 A.2d 925, 948-49 (1982) (Pashman, J., concurring in part and dissenting in part) (arguing that state constitutions must be interpreted separately unless there are good reasons of policy to establish a uniform interpretation). *See infra* notes 114-25 and accompanying text.

[78]Florida v. Casal, 462 U.S. 637, 639 (1983).

[79]State v. Jackson, 672 P.2d 255, 264 (Mont. 1983) (Shea J., dissenting), *overruled*, State v. Johnson, 719 P.2d 1248 (Mont. 1986).

Electoral tensions also arise between state courts and the people. Various states have experienced attempts, some successful, at amending the state constitution to counter independent grounds decisions. One such attempt failed in Washington,[80] but succeeded in California and Florida.[81] Chief Justice Burger may have exacerbated federal-state tensions when he applauded the good sense of the people of Florida for amending their state constitution's analog to the fourth amendment to require judicial conformance with Supreme Court announced fourth amendment standards.[82] These various intra-state and state-federal tensions continue to have a significant impact on state constitutional decisionmaking.

IV. Methods of State Court Analysis

In interpreting the scope of state constitutional provisions, state courts should have as their goal providing their citizens with the protections contemplated by the drafters of the state constitution.[83] Courts, however, choose an approach to state constitutional analysis for a variety of reasons. Often, that choice reveals how a state court perceives its role in the federal structure and what weight it will give to federal precedent. Some courts vary their approach according to the type of civil liberty being protected.[84] In preparing a state constitutional argument, counsel should carefully analyze the approach the state court has chosen. Several approaches or methods have been adopted, including the absolute harmony, primacy, interstitial, and dual sovereignty approaches.[85]

A. The Lock-Step or Absolute Harmony Approach

Some state courts employ a lock-step or absolute harmony approach in interpreting state provisions having federal analogs. In reality, this is a non-approach to state interpretation because it results in "absolute deferential conformity" with Supreme Court interpretations.[86] The absolute harmony approach has a long history. For example, in the early 1920's, when it was widely recognized that the fourth amendment did not apply to the states, several state courts adopted the federal exclusionary rule because they felt bound to conform their interpretations of

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[80]A 1985 bill proposing to substitute fourth amendment language for Wash. Const. art 1, § 7 failed to get out of committee. *See* Comment, *The Origin and Development of Washington's Independent Exclusionary Rule: Constitutional Right and Constitutionally Compelled Remedy*, 61 Wash. L. Rev. 459, 489-90 (1986).

[81]*Id.*

[82]Florida v. Casal, 462 U.S. at 638.

[83]Utter, *supra* note 48, at 1050.

[84]Abrahamson, *supra* note 26, at 1176.

[85]*See* Utter, *supra* note 48, at 1027-30.

[86]*Id.* at 1168.

the state constitution with Supreme Court analysis.[87] More recently, the Texas Court of Criminal Appeals expressed its commitment to absolute harmony with Supreme Court fourth amendment interpretations "until such time as [it is] statutorily or constitutionally mandated to do otherwise."[88]

Absolute harmony has been criticized on a variety of grounds. As we have seen, this approach contradicts the historical relationship between the state and federal constitutions.[89] It is also inconsistent with the roles that state and federal governments play in the classical model of federalism.[90] Most importantly, absolute deference violates a state judge's duty to independently interpret the scope of the state constitution.[91] As a result of these criticisms, state courts continue to struggle with the appropriateness of a lock-step approach. While they follow such an approach in criminal matters, Texas courts do not absolutely defer in civil cases.[92]

Montana provides the best example of a court struggling with absolute harmony. In 1977, the Montana Supreme Court applied the absolute harmony approach to the state privilege against compelled self-incrimination.[93] Then in 1981, Montana adopted an independent grounds approach,[94] only to reassert the absolute harmony approach in the same case after its original decision was vacated by the United States Supreme Court.[95] Most recently, in 1986, the Montana court reversed itself again, making it clear that from now on it would no longer " 'march lock-step' with the United States Supreme Court where constitutional issues are concerned, even if the applicable state constitution provisions are identical or nearly identical to the United States Constitution."[96]

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[87]Comment, *supra* note 80, at 473 n.83.

[88]Brown v. State, 657 S.W.3d 797, 799 (Tex. Crim. App. 1983) (en banc).

[89]*See supra* notes 42-46 and accompanying text; *see also* Linde, *supra* note 1, at 380-83.

[90]*See supra* note 67 and accompanying text; *see also* State v. Badger, 141 Vt. 430, 447-49, 450 A.2d 336, 346-47 (1982).

[91]*See* Baker v. Fairbanks, 471 P.2d 386, 401-02 (Alaska 1970) (court has duty to develop additional constitutional protections if within the intention and import of state constitution); State v. Kimbro, 197 Conn. 219, 234, 496 A.2d 498, 506 (1985) (court has duty to interpret state constitution's civil liberty protections); Alderwood Assocs. v. Washington Envtl. Council, 96 Wash. 2d 230, 237-38, 635 P.2d 108, 113 (1981) (courts are obliged to interpret state constitution).

[92]*See* Abrahamson, *supra* note 26, at 1167 n.96.

[93]State v. Finley, 173 Mont. 162, 164-65, 566 P.2d 1119, 1121 (1977). *See generally* Collins, *Reliance on State Constitutions—The Montana Disaster*, 63 TEX. L. REV. 1095 (1985).

[94]State v. Jackson, 195 Mont. 185, 637 P.2d 1 (1981), *vacated*, 460 U.S. 1030 (1983). *See* Collins, *supra* note 93, at 1095-1102.

[95]State v. Jackson, 672 P.2d 255 (Mont. 1983), *overruled*, State v. Johnson, 719 P.2d 1248 (Mont. 1986). *See* Collins, *supra* note 93, at 1108-11.

[96]State v. Johnson, 719 P.2d 1248, 1254 (Mont. 1986) (holding that unlike under

B. Primacy Approach

On the opposite end of the spectrum from the absolute harmony approach you will find the primacy approach, first articulated by Oregon Supreme Court Justice Hans A. Linde.[97] Under this approach, a state court examines state constitutional issues first, reasoning that a federal question cognizable under the fourteenth amendment's due process clause becomes an issue only if state law does not protect the right in question.[98] Courts using this approach do not consider federal law and analysis presumptively valid, viewing them instead as no more persuasive than decisions of sister state supreme courts.[99] Thus, primacy courts focus on the state constitution as an independent source of rights, rely on it as the fundamental law, and do not address federal constitutional issues unless the state constitution does not provide the protection sought.[100]

The primacy approach flows out of the classical model of federalism by assuming "that the states are the primary sovereigns and that the state constitutions are the basic charters of individual liberties and of the limits of governmental authority."[101] States applying this approach include Oregon,[102] Maine,[103] and New Hampshire.[104]

Commentators identify a variety of benefits of the primacy approach. These include development of a sound body of state constitutional law, protection of state decisions from federal review, and promotion of healthy federalism, in which federal and state courts respect each others' authority in their respective spheres.[105] Although the primacy approach may insulate state decisions from Supreme Court review, state primacy does not necessarily result in state court decisions expanding upon federal minimums.[106]

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federal law, defendant's request to speak with somebody invoked his constitutional right to counsel, but the failure to suppress his tape recorded statements was harmless error in the case at hand).

[97]*See* Linde, *supra* note 1, at 383-84; Linde, *supra* note 64, at 178.

[98]Linde, *supra* note 64, at 178.

[99]*Id.*

[100]Utter, *supra* note 48, at 1028.

[101]Note, *Developments in the Law—The Interpretation of State Constitutional Rights*, 95 HARV. L. REV. 1324, 1357 (1982).

[102]*See, e.g.*, State v. Kennedy, 295 Or. 260, 262-63, 666 P.2d 1316, 1318 (1983).

[103]*See, e.g.*, State v. Cadman, 476 A.2d 1148 (Me. 1984). *See generally* Comment, *supra* note 32. In many instances prior to 1984, Maine's highest court applied constitutional analysis totally dependent upon federal doctrine. State constitutional provisions were tacked on as afterthoughts or characterized as equivalent to their federal counterparts. *Id.* at 499 n.19, 501 n.21. After adopting the primacy approach, the Maine court cites federal cases because it finds them persuasively reasoned, not because it feels bound to do so. State v. Flick, 495 A.2d 339, 343-44 n.2 (Me. 1985); *Cadman*, 476 A.2d at 1150.

[104]*See, e.g.*, State v. Ball, 124 N.H. 226, 230-32, 471 A.2d 347, 350-52 (1983).

[105]*See, e.g.*, Comment, *supra* note 32, at 507-24.

[106]*See, e.g.*, State v. Smith, 301 Or. 681, 725 P.2d 894 (1986) (plurality concluded that Oregon constitution does not require *Miranda*-style warnings); *see also* Comment,

As you would expect, the primacy approach has generated heated criticism. Many commentators argue that the classical federalism model of distinct bodies of law, providing double protection, has become unnecessary due to the extensive incorporation of the federal Bill of Rights.[107] Others contend that the need for nationwide uniformity, at least in the area of criminal law, makes the primacy method ill-advised.[108] I also see the primacy method as creating some problems. In particular, primacy courts often address only the state constitution, resulting in state decisions that do not comment on federal law. Consequently, state courts would no longer play their crucial and historic role in the development of federal jurisprudence.

C. *Interstitial or Supplemental Approach*

Under the supplemental approach, a state court always addresses the federal claim first. Only if the federal claim fails does the court look to the state constitution to determine if it "offers a means of supplementing or amplifying federal rights."[109] This approach flows out of a perceived need to foster uniformity and avoid conflict with federal precedent if at all possible. Apparently, decisions by the Indiana Supreme Court indicate that it will follow this approach.[110]

The supplemental approach differs from both the primacy and absolute harmony models. Unlike under the primacy model, courts using the supplemental approach view federal interpretation of analogous pro-

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supra note 32, at 525 n.95 (arguing that despite Maine's adoption of the primacy approach, expanded state rights remains the exception, not the rule).

[107]*See, e.g.*, Maltz, *The Dark Side of State Court Activism*, 63 TEX. L. REV. 985 (1985); Note, *supra* note 101, at 1336.

[108]*See, e.g.*, People v. Corr, 682 P.2d 20, 33 (Colo.) (Erickson, C.J., dissenting), *cert. denied*, 469 U.S. 855 (1984) (need for state officers to be able to rely on federal interpretations in criminal area); State v. Ringer, 100 Wash. 2d 688, 703, 674 P.2d 1240, 1250 (1983) (Dimmick, J., dissenting) (independent interpretation in criminal area will confound the police); Maltz, *supra* note 107, at 1005; Simon, *supra* note 57, at 318-19 & n.113; Comment, *supra* note 32, at 518-19 n.72.

[109]Utter, *supra* note 48, at 1028.

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> [W]here a provision of a state Constitution is similar in meaning and application to a provision of the federal Constitution, it is desirable that there should be no conflict between the decisions of the state courts and the federal courts on the subject involved. While a decision of the Supreme Court sustaining the validity of a state statute as not violative of any provision of the Fourteenth Amendment is not absolutely binding on the courts of the state when the statute is attacked as being in conflict with a provision of the state Constitution having the same effect, still, the federal decision in such cases is strongly persuasive authority, and is generally acquiesced in by the state courts.

City of Indianapolis v. Wright, 267 Ind. 471, 476, 371 N.E.2d 1298, 1300, 1301 (1978) (citation omitted).

visions as presumptively correct.[111] Unlike courts that follow the absolute harmony approach, under the supplemental approach, state courts do not automatically follow the federal interpretation in construing state provisions.[112] Thus, a similarity between parallel state and federal provisions makes federal precedent persuasive, not binding. Although Indiana often recognizes that it has the power to go beyond the federal minimum, it seldom, if ever does. An interesting comparison can be made with states such as New Hampshire, which often treats parallel state and federal provisions similarly, but also selectively uses its power to afford greater protection under the state constitution.[113]

New Jersey's experience provides an example of the organic development of the supplemental approach. In 1982, in *Right to Choose v. Byrne*,[114] the New Jersey Supreme Court considered the constitutionality of a state statute that restricted Medicaid funding for abortions necessary to save the life of the mother. After finding that the statute did not run afoul of the federal Constitution,[115] the court invalidated the statute under the New Jersey Constitution.[116] In rejecting the federal analysis, the court noted that it would proceed cautiously in interpreting state provisions because of the "general advisability" of uniform interpretations of state and federal analogs.[117] However, because of the significant textual differences between the state and federal due process guarantees and a preexisting New Jersey jurisprudence, the court used its power to independently interpret the state constitution more broadly than the federal minimum.[118]

In *State v. Hunt*,[119] the New Jersey court again used the supplemental approach to hold that, unlike its fourth amendment analog, the state search and seizure provision protected an individual's long distance telephone records. In a concurring opinion, Justice Handler criticized the court's supplemental approach because of the lack of consistent standards to justify departure from federal analysis. Instead, he offered a set of seven neutral criteria to solve the perceived problem.[120] One

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[111]Utter, *supra* note 48, at 1028.

[112]*See* Abrahamson, *supra* note 26, at 1176.

[113]*See, e.g.*, State v. Koppel, 127 N.H. 286, 499 A.2d 977 (1985) (non-random roadblocks violate the state constitution); State v. Ball, 124 N.H. 226, 471 A.2d 347 (1983) (officer's reaching into defendant's automobile to retrieve suspicious-looking cigarette butt violated state constitution).

[114]91 N.J. 287, 450 A.2d 925 (1982).

[115]*See* Harris v. McRae, 448 U.S. 297 (1980).

[116]*Right to Choose*, 91 N.J. at 293, 450 A.2d at 928.

[117]*Id.* at 301, 450 A.2d at 932.

[118]*Id.* at 303, 450 A.2d at 932.

[119]91 N.J. 338, 450 A.2d 952 (1982).

[120]*Id.* at 343-46, 450 A.2d at 965-67 (Handler, J., concurring). The criteria included: textual differences, legislative history, preexisting state law, structural differences between

year later in *State v. Williams*,[121] a majority of the New Jersey court adopted the neutral criteria approach in the context of whether pretrial proceedings should be open.[122] Most recently, in January 1987, the New Jersey court used neutral criteria to support its refusal to adopt, under the state search and seizure provision, the federal good faith exception to the exclusionary rule.[123]

Former New Jersey Supreme Court Justice Morris Pashman has articulated one of the major criticisms of the supplemental approach's neutral criteria. He correctly pointed out that use of criteria creates an unwarranted presumption of validity for federal analysis under the state constitution.[124] According to Justice Pashman, a state court has a duty to interpret the state constitution on its own merits. Thus, "particular reasons" must exist before a state court eschews its responsibility to independently interpret the state constitution in favor of conforming to the Supreme Court's result.[125]

Another major criticism of the supplemental approach focuses on the advisability of relying solely upon federal grounds for state decisions.[126] Massachusetts' experience highlights the problem. In *Commonwealth v. Upton*,[127] the Massachusetts court reversed a conviction for lack of probable cause, grounding its decision solely on the fourth amendment. Because the decision did not involve independent and adequate state grounds, the Supreme Court asserted jurisdiction and reversed,[128] disagreeing with Massachusetts' application of *Illinois v. Gates*.[129]

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state and federal constitutions, matters of particular local or state interest, state traditions or history, and particular attitudes of the state's citizens. Washington has adopted a similar set of nonexclusive criteria. State v. Gunwall, 106 Wash. 2d 54, 720 P.2d 831 (1986).

[121]93 N.J. 39, 459 A.2d 641 (1983).

[122]*Id.* at 57-58, 459 A.2d at 650. Despite New Jersey's attempt to develop a set of neutral principles underlying its supplemental approach, it has not escaped criticism. *See* Note, *The New Jersey Supreme Court's Interpretation and Application of the State Constitution*, 15 RUTGERS L.J. 491, 499-505 (1984) (suggesting that the court arbitrarily applies its neutral criteria).

[123]State v. Novembrino, 105 N.J. 95, 519 A.2d 820 (1987).

[124]*See Hunt*, 91 N.J. at 355, 450 A.2d at 960 (Pashman, J., concurring). Justice Handler argued that by proposing neutral criteria, he did not intend to create a presumption favoring federal analysis. *See id.* at 367 n.3, 450 A.2d at 967 n.3; Handler, *Expounding the State Constitution*, 35 RUTGERS L. REV. 202, 206 n.29 (1983).

[125]*Hunt*, 91 N.J. at 355, 450 A.2d at 960 (Pashman, J., concurring). *See generally* Cohn, *Justice Pashman as Federalist: The New Jersey Constitution Unbound*, 35 RUTGERS L. REV. 213 (1983). For further discussion of the New Jersey approach, see Handler, *supra* note 124; Pollock, *State Constitutions as Separate Sources of Fundamental Rights*, 35 RUTGERS L. REV. 707 (1983).

[126]*See* Massachusetts v. Upton, 466 U.S. 727, 735 (1984) (Stevens, J., concurring).

[127]390 Mass. 562, 458 N.E.2d 717, *rev'd*, 466 U.S. 727 (1983).

[128]Massachusetts v. Upton, 466 U.S. 727 (1983).

[129]*Id.*

On remand, the Massachusetts court turned to the state constitution, independently adopted the two-prong *Aguilar-Spinelli* probable cause test, and affirmed its earlier decision.[130] United States Supreme Court Justice John Paul Stevens criticized Massachusetts' use of the supplemental approach, characterizing it as creating needless work for the Supreme Court and unnecessarily inviting Supreme Court review and possible reversal.[131] Finally, Massachusetts' experience highlights Justice Linde's criticism of the supplemental approach. Because the supplemental approach requires review of the state constitution only when federal doctrine fails to provide protection, state court decisions that provide broader protection run the risk of being criticized as pragmatic and result oriented, rather than principled.[132]

D. *Dual Sovereignty Approach*

Thus far we have seen the strengths and weakness of the absolute harmony, primacy, and supplemental approaches. Several state courts have adopted another model, the dual sovereignty approach,[133] which attempts to use the other approaches' strengths while avoiding their weaknesses. Under this approach, courts always evaluate both federal and state constitutional provisions, reaching conclusions as to the protection afforded under each, even if the decision rests firmly on state grounds.[134] According to Vermont Supreme Court Justice William C. Hill, who calls this the "Vermont approach," reaching independent decisions under both constitutions "accommodates, rather than evades, the relationship of state and federal constitutional rights."[135]

A Washington case offers an excellent example of the approach at work. In *State v. Coe*,[136] the trial court held a radio and television station in contempt for violating a court order prohibiting the broadcast of accurate, lawfully obtained copies of tape recordings played at a criminal trial. We first analyzed the trial court's prior restraint order under Washington's free speech provision, the text of which differs significantly from its federal analog.[137] We concluded that the Washington Constitution absolutely forbade prior restraints against publication or

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[130]Commonwealth v. Upton, 476 N.E.2d 548 (Mass. 1985).

[131]Massachusetts v. Upton, 466 U.S. at 735 (Stevens, J., concurring).

[132]Linde, *supra* note 64, at 178.

[133]*See, e.g.*, State v. von Bulow, 475 A.2d 995 (R.I.), *cert. denied*, 469 U.S. 875 (1984); Kearns-Tribune Corp. v. Lewis, 685 P.2d 515 (Utah 1984); State v. Badger, 141 Vt. 430, 450 A.2d 336 (1982); State v. Coe, 101 Wash. 2d 364, 679 P.2d 353 (1984).

[134]*See* Utter, *supra* note 48, at 1029.

[135]Hill & Marks, *Foreword: Toward a Federalist System of Rights*, 1984 Ann. Sur. Am. L. 1, 11.

[136]101 Wash. 2d 364, 679 P.2d 353 (1984).

[137]*Compare* Wash. Const. art. 1, § 5 *with* U.S. Const. amend. I.

broadcast of constitutionally protected speech.[138] We then turned to the federal Constitution, holding that the first amendment also prohibited prior restraints against the broadcast in question.[139] Other states that have employed the dual sovereignty approach, notably Rhode Island, Utah, and Vermont, differ from our approach in *Coe* only to the extent that they address the federal issue prior to discussing the state constitution.[140]

In addition to authoring the *Coe* opinion, I have written separately in the *Texas Law Review* in support of the dual sovereignty approach.[141] In some ways reaching dual decisions under the federal and state constitutions was the original method of constitutional analysis.[142] "It reflects the policies underlying our federal system by making available the maximum protection both levels of government offer to citizens."[143] The major criticism lodged against the dual sovereignty approach is that once a court affords protection under the provision analyzed first, subsequent discussion under the other constitution constitutes dicta, unnecessary to the final disposition of the case.[144] In addition, Justice Stewart G. Pollock of the New Jersey court thinks that the dual approach may lead to a "body of state law that merely mimics the federal rulings."[145] Mimicry, he correctly pointed out, would be inconsistent with federalist principles that underlie state independent analysis.[146] My *Texas Law Review* article attempted to rebut such criticisms by focusing on the need to accommodate a state court's duty to interpret its own constitution and the crucial role state court commentary has played in the development of federal jurisprudence.[147] Moreover, unlike Justice Pollock, I see the dual sovereignty approach as facilitating the primary goal of a state court: development of a principled, independent state jurisprudence.

V. Formulating State Constitutional Arguments

Regardless of which approach a court takes, state constitutional law consists of state court pronouncements based on federal constitutional

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[138]*Coe*, 101 Wash. 2d at 375, 679 P.2d at 361.

[139]*Id.* at 380, 679 P.2d at 363.

[140]*See, e.g.*, State v. von Bulow, 475 A.2d 995 (R.I.), *cert. denied*, 469 U.S. 875 (1984); Kearns-Tribune Corp. v. Lewis, 685 P.2d 515 (Utah 1984); State v. Badger, 141 Vt. 430, 450 A.2d 336 (1982).

[141]*See generally* Utter, *supra* note 48.

[142]*Id.* at 1029.

[143]*Id.*

[144]*See, e.g.*, Collins, *supra* note 93, at 1101 n.60; Linde, *supra* note 64, at 176 & n.26.

[145]Pollock, *supra* note 125, at 718.

[146]*Id.*

[147]Utter, *supra* note 48, at 1030-50.

precedent and analytics, as well as state court decisions that depart significantly from the federal model. In addition, adherence to a particular analytical approach is by no means set in concrete. Thus, you must become familiar with the various approaches in order to frame a persuasive state constitutional argument on behalf of your client. In most states, framing a state constitutional argument presents counsel with largely uncharted territory. State courts often observe that even where parties squarely raise state constitutional issues, briefing frequently falls short of the mark, failing to make any substantive analysis or argument on the issue.[148] Even where state courts demonstrate a willingness to carefully review state issues, as we have in Washington, lawyers often view state issues as "throw-ins" most likely because they have not learned how to frame well thought out, persuasive state constitutional arguments.[149] For this reason, I will attempt to provide you with some fundamentals useful for building your state analysis.[150] Keep in mind that your goal is to persuade a state court to examine its state constitution and to find that because of its historical mandate or other factors, a decision favoring your client is required.[151]

A. *Structural Considerations*

In structuring your argument, you need to consider the effect of topics we have discussed thus far. To take account of a state court's role and responsibility in our federal system, you should present your state constitutional analysis at each stage of the proceedings—prior to trial, during trial, and on appeal. The bona fide, independent grounds requirement announced in *Michigan v. Long*[152] affects your structural presentation in several ways. You must take care to keep your state and federal claims separate and distinct. To do so you should refer specifically to the state provisions upon which you rely, separate your federal and state analysis, and be sure to set out your state law position as a separate argument in all written documents.[153]

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[148]*See, e.g.*, State v. Jewett, 146 Vt. 221, 223-29, 500 A.2d 233, 234-36 (1985) (court admonished parties for their inadequate briefs and ordered supplemental briefing on the state issues).

[149]Justice Shirley Abrahamson has made a similar observation concerning Wisconsin. Abrahamson, *supra* note 26, at 1163.

[150]For other discussions of techniques to effectively argue state constitutional issues, see Bamberger, *supra* note 37; Carson, *supra* note 2, at 658-62; Tinkle, *The Resurgence of State Constitutional Law*, 18 Me. Bar. Bull. 257, 288-91 (1984); Utter, *supra* note 6, at 504-24; Comment, *supra* note 32, at 544-87.

[151]Utter, *supra* note 6, at 504-07.

[152]*See supra* notes 74-76 and accompanying text.

[153]*See* Bamberger, *supra* note 37, at 50.

As Wisconsin Supreme Court Justice Shirley Abrahamson observed, a state court's choice of approach to state constitutional interpretation may reflect the court's view of the relation between the state and federal constitutions.[154] As a result, you may wish to order your presentation of federal and state claims to reflect the approach your state court adopts. Thus, in primacy states, discuss state issues first; in supplemental states, discuss your federal claim prior to your state claim; and in dual sovereignty states—since different states order their issue consideration differently—become aware of your state's choice. In addition, as discussed above, some supplemental approach states employ neutral criteria.[155] Consequently, you may wish to order your discussion of the state constitution by referring to the list of criteria and by proposing additional criteria.

B. Argument Building Blocks

Commentators and jurists often refer to various types of constitutional arguments including textual, historical, doctrinal, prudential, structural, and ethical.[156] For example, the Vermont Supreme Court encourages parties to focus on the textual approach, supported by reference to historical, economic, and social materials.[157] For the purposes of today's discussion, I will focus briefly on the use of constitutional text, state constitutional history, preexisting state jurisprudence, and current values.

1. Constitutional text.—The text of the constitutional provision in question provides the starting point for building your argument. In framing your textual argument, feel free to apply the general maxims of statutory construction.[158] Keep in mind the differences between constitutions and statutes. Where the people ratified the provision you rely upon, the common and ordinary meaning of the constitutional language is the meaning understood by the majority of voters, or as the Wisconsin Supreme Court put it, by "the general run of voters to whom the [provision] was submitted."[159] As an additional aid in framing your textual argument, look also to the Enabling Act which paved the way for and set limits on the state constitutional convention.

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[154]Abrahamson, *supra* note 26, at 1169.

[155]*See supra* notes 120-25 and accompanying text.

[156]*See, e.g.*, P. Bobbitt, Constitutional Fate: Theory of the Constitution (1982); *see also* State v. Jewett, 146 Vt. 221, 234, 500 A.2d 233, 237 (1985) (court referred parties to Professor Bobbitt's work); Linde, *supra* note 64, at 180-93 (discussing the various constitutional arguments).

[157]*Jewett*, 146 Vt. at 234, 500 A.2d at 237.

[158]Utter, *supra* note 6, at 509; *see In re* Todd, 208 Ind. 168, 193 N.E. 865 (1935) (rules for construing statutes should be applied to constitutional provisions).

[159]B.F. Sturtevant Co. v. O'Brien, 186 Wis. 10, 19, 202 N.W. 324, 327 (1925).

Your textual argument will have to take into account the existence of federal analogs. Where the state constitution guarantees a right unaddressed in the federal Constitution, your job is much easier. For example, article 1, section 12 of the Indiana Constitution specifically recognizes that every person shall have a remedy by due course of law for injuries to his or her reputation.[160] The federal Constitution recognizes no constitutional right to a reputation.[161] However, several state courts have relied on provisions nearly identical to article 1, section 12 to hold that reputation is a fundamental constitutional interest.[162] Recognition of reputation as a fundamental interest has far reaching implications for your client. Once recognized as such an interest, state infringement arguably gives rise to a section 1983 federal civil rights action.[163]

Where a substantive protection analog exists, the difficulty of your job increases. Nevertheless, few provisions of a state's constitution, including Indiana's, contain precisely the same language as their federal protection analogs. In framing your argument, you must persuade your state's judiciary to assign meaning to that textual difference. In Washington, our fourth amendment analog, article 1, section 7, provides that "[n]o person shall be disturbed in his private affairs, or his home invaded, without authority of law."[164] The Washington Supreme Court gives substantive meaning to this textual departure from the fourth amendment. For example, in *State v. Myrick*,[165] we rejected the federal open fields exception to the warrant requirement as inapplicable under our state constitution. While open fields do not come within the limited scope of fourth amendment protection—that is, persons, homes, papers, and effects—section 7's protection sweeps much broader by guaranteeing the sanctity of one's "private affairs," as well as one's home.[166]

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[160]Ind. Const. art. 1, § 12.

[161]Paul v. Davis, 424 U.S. 693 (1976) (federal courts lack authority to hear claims based on a right to reputation).

[162]*See, e.g.*, Gobin v. Globe Publishing Co., 216 Kan. 223, 531 P.2d 76 (1975) (individual may recover damages to reputation under state constitution); McCall v. Courier-Journal, 623 S.W.2d 882 (Ky. 1981) (state constitution protected attorney from defamation by newspaper), *cert. denied*, 456 U.S. 975 (1982); Madison v. Yunker, 180 Mont. 54, 589 P.2d 126 (1978) (retraction statute unconstitutional as incomplete remedy); Davidson v. Rogers, 281 Or. 219, 574 P.2d 624 (reputation is constitutionally protected but retraction statute does not violate remedy guarantee). Montana has relied on a guaranteed remedy provision similar to Indiana's to invalidate municipal immunity for torts. White v. State, 661 P.2d 1272, 1273-75 (Mont. 1983).

[163]42 U.S.C. § 1983 (1981). *See* Paul v. Davis, 424 U.S. 693 (1976).

[164]*Compare* Wash. Const. art 1, § 7 *with* U.S. Const. amend. IV.

[165]102 Wash. 2d 506, 688 P.2d 151 (1984).

[166]*Id.* at 512, 688 P.2d at 155.

Your job becomes most difficult when the state provision has a language analog in the federal constitution. When the state constitution employs language identical or nearly identical to federal provisions, state courts come under pressure to conform their decisions to federal precedent. This pressure is particularly acute in the criminal area.[167] Nevertheless, you must overcome the notion that the divergence from the Supreme Court becomes more legitimate when the state constitution has different text.[168] In either case, state courts have equal responsibility for independently interpreting their state constitutions; a textual difference simply makes it easier for a court to see its responsibility.[169]

Take article 1, section 11 of the Indiana Bill of Rights, which contains language identical to the federal fourth amendment. A state court must seek to discover what the people of Indiana meant by the wording of article 1, section 11. When Indiana's framers drafted section 11 in 1816 and readopted it in 1851, the United States Supreme Court's first significant interpretation of the fourth amendment was still thirty-five years in the future.[170] Undoubtedly, given the independent development of state constitutions, the Indiana framers never intended section 11 to be dependent upon, or interpreted in light of, the fourth amendment.[171] Moreover, significant structural differences exist between state and federal bills of rights. State charters recognize affirmative rights, while the federal charter places limits on federal power.[172] In addition, the differing perspectives of state and federal courts require significantly different analysis of similarly worded provisions.[173]

Regardless of the similarity in constitutional text and regardless of whether a state court looks to the state constitution before, after, or simultaneous with the federal Constitution, you should feel free to adopt modes of analysis that differ from those employed by the United States Supreme Court.[174] State constitutions offer counsel and the courts the ability to be free of inconsistencies, complexities, and restrictions of federal case law.[175] Once free of federal analytics, both counsel and court can rethink fundamental issues involved.[176] In drafting your state

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[167]*See* Abrahamson, *supra* note 26, at 1155 ("criminal law is probably the most public and controversial arena . . . . ").

[168]Linde, *supra* note 64, at 182.

[169]*Id.*

[170]*See* Boyd v. United States, 116 U.S. 616 (1886); Comment, *supra* note 80, at 520 n.318.

[171]*See* Utter, *supra* note 6, at 496.

[172]*Id.* at 494. *See generally* Barron v. Mayor of Baltimore, 32 U.S. (7 Pet.) 243 (1833).

[173]Utter, *supra* note 48, at 1042.

[174]Utter, *supra* note 6, at 506.

[175]Abrahamson, *supra* note 26, at 1181; Utter, *supra* note 6, at 506.

[176]*Id.*

argument, you should heed the Vermont Supreme Court's advice and avoid the "litany of federal buzz words."[177] If you incorporate federal analysis and law into your state analysis, do so only after careful thought.

2. *Use of State Constitutional History.*—To support your textual argument and to shed light on ambiguous constitutional language, look to the original intent and understanding underlying the constitutional provision. Because a state constitution is the expression of the people's will, a state court must be concerned primarily with the intent of those who ratified the document.[178] Evidence of the drafters' intent becomes important because, in many cases, it is the only evidence we have of the people's understanding.[179] In general, historical arguments focus on the legislative history of a particular clause or provision, the treatment the clause or provision received in subsequent constitutions, and the social and political setting in which the provision originated or when the changes took place.[180]

To frame your argument you should look to the various sources, both primary and secondary, which shed light on the original understanding of a particular state provision. As in any historical research project, primary sources provide the best building blocks for your argument. Look to the Enabling Act, which authorized the State Constitutional Convention's work, and to available published records of the state convention. The Indiana Supreme Court considers state constitutional convention debates as an important tool for interpreting its constitution.[181] In Washington, unfortunately, full proceedings of the state convention have not been made available. Nevertheless, the brief minutes in the convention journal reveal that the Washington framers rejected fourth amendment language in favor of the text of article 1, section 7.[182] This decision to reject federal wording, along with article 1, section 7's broad language, formed the basis of Washington's independent analysis of search and seizure cases under the state constitution.[183] In contrast to Washington's lack of primary sources, in Indiana you have a rich supply of primary sources from both the 1816[184] convention and the revisions adopted in 1851.[185]

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[177] State v. Jewett, 146 Vt. 221, 223, 500 A.2d 233, 235 (1985).

[178] Utter, *supra* note 6, at 511.

[179] *Id.*

[180] Linde, *supra* note 64, at 183.

[181] *See In re* Todd, 208 Ind. 168, 183 N.E. 865 (1935).

[182] WASHINGTON JOURNAL, *supra* note 1, at 51, 497.

[183] *See, e.g.*, State v. Jackson, 102 Wash. 2d 432, 443, 688 P.2d 136, 141 (1984). For a critique of Washington's use of article 1, § 7, see Nock, *Seizing Opportunity, Searching for Theory: Article I, Section 7*, 8 U. PUGET SOUND L. REV. 331 (1984).

[184] *See, e.g.*, JOURNAL OF THE CONVENTION OF THE INDIANA TERRITORY (Louisville 1816).

[185] *See, e.g.*, JOURNAL OF THE CONVENTION OF THE STATE OF INDIANA TO AMEND THE CONSTITUTION (1851); REPORT OF THE DEBATES AND PROCEEDINGS OF THE CONVENTION OF

Substantial insight can also be gained from newspaper accounts of the constitutional convention, as well as from looking to the constitutions that the Indiana delegates copied from or referred to in drafting specific provisions.[186] However, as noted earlier,[187] even where the Indiana Constitution contains the same or similar language to the federal or other state constitutions, it is quite possible that the framers intended something different from those who drafted the source documents.

As to secondary sources, you can rely on the writings of individual framers as indicative of the intent underlying particular provisions. In Indiana, for example, Robert Dale Owen was a prominent and influential delegate to the 1852 Convention.[188] Consequently, books by and about Owen may offer additional insights into the meaning of various civil liberty guarantees.[189] Other secondary sources include books and articles that concern the convention itself or that detail the history of events leading up to the framing and ratification of the state constitution.[190]

3. Reference to Current Values.—A court's primary goal in determining the scope of a constitutional provision is to give effect to the intent of the framers of the state constitution. Utilizing "interpretivist" review,[191] courts determine original intent by using the textual analysis and historical sources discussed above. In contrast, under a noninterpretative review,[192] courts look to current values such as sound policy, justice, and fundamental fairness to shed light on the scope of a constitutional protection.[193] The pros and cons of the United States Supreme Court's use of the competing approaches have been debated extensively in the literature.[194] As can be expected, the debate over the appropriateness

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THE REVISION OF THE CONSTITUTION OF THE STATE OF INDIANA (1850). For comments about the Indiana constitution, see generally OREGON PROCEEDINGS, *supra* note 1.

[186]*See* Barnhart, *Sources of Indiana's First Constitution*, 49 IND. MAG. HIST. 55 (1943).

[187]*Supra* notes 170-72 and accompanying text.

[188]R. LEOPOLD, ROBERT DALE OWEN 269 (1969); Madison Courier, Feb. 10, 1851.

[189]*See, e.g.*, R. LEOPOLD, *supra* note 182; R.D. OWEN, TREADING MY WAY (New York 1874); R.D. OWEN, THE WRONG OF SLAVERY (Philadelphia 1864).

[190]*See, e.g.*, J. BARNHART & D. RIKER, INDIANA TO 1816 (1971); CONSTITUTION MAKING IN INDIANA- 1916-1978 (Kettleborough ed. 1979); D. DUNN, INDIANA AND INDIANANS (1919); Barnhart, *supra* note 186; Dionisopoulos, *Indiana, 1851, Alaska, 1956: A Century of Differences in State Constitutions*, 34 IND. L.J. 34 (1958-59); Lambert & McPheron, *Modernizing Indiana's Constitution*, 26 IND. L.J. 185 (1950-51); Twomley, *supra* note 2.

[191]*See* J. ELY, DEMOCRACY AND DISTRUST 1 (1980).

[192]*Id.*

[193]People v. P.J. Video, Inc., 68 N.Y.2d 296, 501 N.E.2d 556, 508 N.Y.S.2d 907 (1986); White, *Reflections on the Role of the Supreme Court: The Contemporary Debate and the "Lessons" of History*, 63 JUDICATURE 162, 166-67 (1979) (using the terms supraprofessionalist and intraprofessionalist in place of noninterpretivist and interpretivist).

[194]*Compare* White, *supra* note 193 (arguing that "[w]hen the Supreme Court decides constitutional cases, it is justified in looking beyond the Constitution to the values of American society today") *with* Downs, *Judges, Law-making and the Constitution: A*

of constitutional review based on judicial perception of current values now takes place in the state supreme court forum as well.[195]

Understandably, state judges may feel reluctant to interpret a constitutional provision by referring to their perceptions of current values. Nevertheless, situations arise that require a state court to employ a noninterpretative review. Determining the intent of a single person is often a difficult chore; yet, the task grows "geometrically more complex" when courts attempt to assess the intent of delegates to a constitutional convention that took place one or two centuries ago.[196] Sometimes little practical objective guidance exists concerning the original intent and understanding of a particular provision.[197] Often the text is ambiguous or unclear, or the intent of the people and framers is undiscoverable or obscure. More importantly, the original intent or understanding of a constitutional provision may become inappropriate in the context of modern conditions and values.[198]

The larger principle contained in a constitutional guarantee should not be confined to what the generation that adopted it was willing to live by.[199] For example, at the time of the Indiana Constitutional Convention of 1851, delegates had conflicts over the right of married women, "negroes," and "mulattos" to acquire property.[200] This conflict led to

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Response to Professor White, 63 Judicature 444 (1979) (arguing that "[w]hen the Supreme Court substitutes its judgment for that of Congress, it steps outside its constitutional role—and endangers both law and democracy").

[195]*See, e.g.*, Maltz, *supra* note 107 (arguing that state courts should only use interpretivist review in construing state constitutional provisions). Wisconsin Justice Shirley Abrahamson has predicted that state constitutional interpretation will raise

> the questions posed in the ongoing debate as to the legitimacy of judicial review of constitutional questions by the United States Supreme Court. Thus, the academicians ask whether state courts shall adopt an interpretative or a non-interpretative approach to their state constitutions; whether state courts will take an historical approach or a doctrinal approach; whether judicial review by state courts and elected judges is countermajoritarian; whether the ease of amending the state constitution affects the manner of interpreting the state constitution. The academicians ask us to consider the questions being discussed in the writings of Dean Jesse Choper, Dean John Ely, Professor Phillip Bobbitt, Professor Michael Perry, and others. The academicians raise important issues—issues that state courts have dealt with in the related area of statutory interpretation and will have to consider in interpretation of the state constitutions.

Abrahamson, *Homegrown Justice: The State Constitutions*, in Developments in State Constitutional Law: The Williamsburg Conference 308 (B. McGraw Ed. 1985).

[196]Rakove, *Mr. Meese, Meet Mr. Madison*, Atlantic Monthly, Dec. 1986, at 77, 78.

[197]Utter, *supra* note 6, at 520.

[198]*Id.*

[199]Linde, *supra* note 64, at 182.

[200]Twomley, *supra* note 2, at 213. The 1851 Constitution did, however, outlaw slavery and involuntary servitude. Ind. Const. art. 1, § 37.

the express decision to leave the inalienable right to acquire property out of the list of specific inherent and inalienable rights guaranteed by article 1, section 1 of the Indiana Constitution.[201] Today, few would argue that Indiana courts should refuse to look to modern values in order to honor the inferior legal position assigned to blacks and women in 1851. As Washington courts have long recognized, a state constitution is "designed to endure through the years, and constitutional provisions should be interpreted to meet and cover changing conditions of social and economic life."[202]

Within the past few months, the New Jersey Supreme Court, in *State v. Novembrino*,[203] and the New York Court of Appeals, in *People v. P.J. Video, Inc.*,[204] employed noninterpretative review to construe their state search and seizure provisions as providing broader protection than their fourth amendment analog. Because of the identity of language between the fourth amendment and the state analogs,[205] and because of the history of the state provisions, both courts acknowledged that interpretivist review offered no grounds for providing broader protection.[206] Nevertheless, in *Novembrino*, New Jersey refused to adopt the United States Supreme Court's good faith exception to the exclusionary rule because of "particular state interests" such as "the likely [negative] impact . . . on privacy . . . and on the enforcement of [New Jersey's] criminal laws."[207] In *P.J. Video*, a case implicating both the right of free expression and the right to be free from unlawful government

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[201]Twomley, *supra* note 2, at 213.

[202]State *ex rel.* Evans v. Brotherhoods of Friends, 41 Wash. 2d 133, 147, 247 P.2d 787, 795 (1952) (quoting State *ex rel.* Linn v. Superior Court, 20 Wash. 2d 138, 145, 146 P.2d 543, 547 (1944)).

[203]State v. Novembrino, 105 N.J. 95, 519 A.2d 820 (1987).

[204]People v. P.J. Video, Inc., 68 N.Y.2d 296, 501 N.E.2d 556, 508 N.Y.S.2d 907 (1986). The New York court listed the various noninterpretative factors it looks for as follows:

> any preexisting State statutory or common law defining the scope of the individual right in question; the history and traditions of the State in its protection of the individual right; any identification of the right in the State Constitution as being one of peculiar State or local concern; and any distinctive attitudes of the State citizenry toward the definition, scope or protection of the individual right.

Id. at 303, 501 N.E.2d at 560, 508 N.Y.S.2d at 911.

[205]*Compare* U.S. Const. amend. IV *with* N.Y. Const. art. 1, § 5; N.J. Const. art. 1, para. 7.

[206]*Novembrino*, 519 A.2d at 849-50; *P.J. Video*, 68 N.Y.2d at 304, 501 N.E.2d at 561, 508 N.Y.S.2d at 912.

[207]*Novembrino*, 519 A.2d at 850. The court noted that "[a]lthough the language of article 1, paragraph 7 of the New Jeresy Constitution is virtually identical with that of the Fourth Amendment, we have held in other contexts that it affords our citizens greater protection against unreasonable searches and seizures than does the Fourth Amendment." *Id.* (citations omitted).

intrusions, the New York court relied on principles of federalism and New York's long tradition of protecting fundamental rights, and refused to apply the *Illinois v. Gates*[208] "totality of the circumstances" test to determine probable cause.[209]

4. *Preexisting State and Federal Law.*—Framing a state argument becomes more difficult when the United States Supreme Court relaxes federal minimum standards. This becomes a jurisprudential problem when the Supreme Court overrules or reinterprets a large body of federal law that state courts have consistently applied.[210] Once a state supreme court decides a state case using federal standards, does the decision continue to bind state courts even when the United States Supreme Court changes direction?[211] A state supreme court has two choices: it can adopt the new federal standard without much comment, or it can squarely address state cases applying the old federal doctrinal analysis and decide whether those standards had evolved into state constitutional requirements.[212] For example, in *Novembrino* and in *P.J. Video*, the New Jersey and New York courts chose to continue adhering to preexisting federal and state law because it proved more persuasive on legal and normative grounds than more recent Supreme Court interpretations of the fourth amendment.[213] Thus counsel must be prepared to argue the question.

Counsel should take notice of the analysis state courts use in rejecting or following new Supreme Court doctrine. For example, state supreme courts have had varied reactions to *Illinois v. Gates*.[214] In *Gates*, the Supreme Court abandoned the well established *Aguilar-Spinelli* two-pronged probable cause test[215] in favor of the less demanding "totality of the circumstances" analytic.[216] Although they had applied the two-prong approach for many years, some state courts simply changed direction with the Supreme Court and followed *Gates*.[217] In *State v.*

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[208] 462 U.S. 213 (1983).

[209] *P.J. Video*, 68 N.Y.2d at 305, 501 N.E.2d at 562, 508 N.Y.S.2d at 913. The court observed that although the identity of text often called for federal-state uniformity, it does not hesitate to adopt independent standards "when doing so best promotes 'predictability and precision in judicial review of search and seizure cases and the protection of the individual rights of our citizens.' " *Id.* (citations omitted).

[210] Comment, *supra* note 32, at 527-28.

[211] Linde, *supra* note 64, at 177.

[212] *See* Comment, *supra* note 32, at 527-28 (criticizing the Maine court for failing to address the issue of the evolution of independent state standards).

[213] *Novembrino*, 519 A.2d at 857; *P.J. Video*, 68 N.Y.2d at 305, 501 N.E.2d at 562, 508 N.Y.S.2d at 913.

[214] 462 U.S. 213 (1983).

[215] *See* Spinelli v. United States, 393 U.S. 410 (1969); Aguilar v. Texas, 378 U.S. 108 (1964).

[216] 462 U.S. at 238.

[217] *See, e.g.*, Beemer v. Commonwealth, 665 S.W.2d 912, 915 (Ky. 1984); Potts v.

Jackson,[218] the Washington Supreme Court rejected *Gates* and continued to employ the *Aguilar-Spinelli* test as a matter of state constitutional law.[219] A number of states have done likewise.[220] In *Jackson*, we based our decision to reject the *Gates* standard on several factors. We found the Court's rationale for departing from the *Aguilar-Spinelli* standard singularly unpersuasive; the *Gates* approach lacked "sufficient specificity and analytical structure to adequately inform magistrates as to the appropriate standards required to protect the right of privacy secured by [the state constitution]."[221] Finally, Washington had an established jurisprudence in which the *Aguilar-Spinelli* test was applied under the state constitution.[222]

Even in the absence of a pre-existing state jurisprudence that applied federal doctrine under the state constitution, state courts often find that state constitutions require rejection of Supreme Court departures from established law. A 1986 New York Court of Appeals case, *People v. Bethea*,[223] illustrates the point. Several years ago, in *People v. Chapple*,[224] the New York Court of Appeals interpreted the federal *Miranda* doctrine as requiring suppression of defendant statements made after proper warnings, when they came in close sequence with prior unwarned statements.[225] Recently, the United States Supreme Court, in *Oregon v. Elstad*,[226] held that interpretations such as *Chapple* misconstrued federal law. Only if the police coerced the unwarned statements would the subsequent warned statements have to be suppressed.[227] In *Bethea*, the New York court had to determine whether *Chapple* remained good law in New York.[228] The court of appeals rejected the *Elstad* approach. Despite the lack of pre-existing state cases applying *Chapple* under the

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State, 300 Md. 567, 575-76, 479 A.2d 1335, 1340 (1984); State v. Arrington, 311 N.C. 633, 643, 319 S.E.2d 254, 261 (1984). New Jersey decided to follow *Gates* as a matter of state law. *Novembrino*, 519 A.2d at 857. Maine opted to follow *Gates* without addressing the state constitutional issue. State v. Knowlton, 489 A.2d 529, 532 (Me. 1985). *See* Comment, *supra* note 32, at 527-28 n.11 (pointing out that despite both its adoption of the primacy approach and the fact that the defendant squarely raised the state constitutional issue, the Maine court did not acknowledge any state constitutional issue).

[218] 102 Wash. 2d 432, 688 P.2d 136 (1984).

[219] *Id.* at 438-39, 688 P.2d at 143.

[220] *See, e.g.*, State v. Jones, 706 P.2d 317 (Alaska 1985); State v. Kimbro, 197 Conn. 219, 496 A.2d 498 (1985); Commonwealth v. Ford, 394 Mass. 421, 476 N.E.2d 560 (1985); People v. Johnson, 66 N.Y.2d 398, 488 N.E.2d 439, 497 N.Y.S.2d 618 (1985).

[221] *Jackson*, 102 Wash. 2d at 443, 688 P.2d at 143.

[222] *Id.*

[223] 67 N.Y.2d 367, 493 N.E.2d 937, 502 N.Y.S.2d 713 (1986).

[224] 38 N.Y.2d 112, 341 N.E.2d 243, 378 N.Y.S.2d 682 (1975).

[225] *Chapple*, 38 N.Y.2d at 114, 341 N.E.2d at 246, 378 N.Y.S.2d at 685.

[226] 470 U.S. 298 (1985).

[227] *Id.* at 318.

[228] 67 N.Y.2d at 366, 493 N.E.2d at 938, 502 N.Y.S.2d at 714.

state constitution, the New York court continued the *Chapple* rule as "a matter of state constitutional law." In refusing to follow *Elstad*, the court observed that without the *Chapple* rule, the state privilege against self-incrimination would lose all deterrent effect.[229]

As a result of the Warren Court's expansion of civil liberties, pre-existing federal law almost always aids a more expansive view of the state constitution. By contrast, pre-existing state precedent, dating back to preincorporation days, often fails to adequately assure and protect state constitutional rights.[230] Consequently, when the Supreme Court curtails federal minimum protections, state courts must look to preincorporation cases as a starting point for their analysis. During the preincorporation period, few states developed a theoretical basis to build a principled civil rights jurisprudence. Thus, these preincorporation cases challenge courts, counsel, and scholars to analyze prior case law's underlying principles and theoretical bases in light of the plain, historical, or modern meaning assigned to the constitutional text.

Ironically, Oregon, one of the leading state constitutional law courts, provides the most vivid example of the struggle with the limitations of preincorporation case law. Just this past year, the defendant in *State v. Smith*[231] relied solely on Oregon's privilege against compelled self-incrimination to argue that the state constitution required *Miranda*-style warnings to be given at an earlier time than required under federal law.[232] This argument raised the threshold issue of whether the Oregon Constitution required *Miranda* warnings at all. The plurality examined cases, dating back to 1896, finding that although Oregon statutes and the Oregon Constitution required a magistrate to explain the right to remain silent, there was "no question" that the state constitution did not require a police officer to give similar warnings.[233] In dissent, Justice Linde pointed to several recent cases, arguing that in each the Oregon court held that Oregon law independently required warnings before interrogation.[234] The plurality characterized the same cases as merely

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[229]*Id.* at 368, 493 N.E.2d at 938-39, 502 N.Y.S.2d at 714-15.

[230]*See* Simon, *supra* note 57, at 311 (prior to incorporation little judicial concern existed for the protection of free expression and other civil rights).

[231]301 Or. 681, 725 P.2d 894 (1986).

[232]*Id.* at 684, 725 P.2d at 896.

[233]*Id.* at 687-98, 725 P.2d at 897-904. In one prior case the Oregon Supreme Court held that "[a]n extra-judicial confession is admissible in this State even though the officer to whom it was made did not inform the accused of his right to consult counsel, of his own right to remain silent and of the fact that his declarations would be used against him." State v. Henderson, 182 Or. 147, 173, 184 P.2d 392, 403 (1947) (citations omitted).

[234]*Smith*, 301 Or. at 703-05, 725 P.2d at 907-08 (Linde, J., dissenting) (citing State v. Sparklin, 296 Or. 85, 672 P.2d 1182 (1983); State v. Mains, 295 Or. 640, 669 P.2d 1112 (1983)).

assuming, without deciding, that the Oregon Constitution required *Miranda*-style warnings.[235] Because it found Oregon statutes and case law provided sufficient protection against coerced statements, the plurality found "no good reason" to overrule preincorporation case law to interpret the state constitution as requiring extrajudicial warnings.[236]

Cases such as *Elstad* will require state courts to evaluate preincorporation state law. Many states, including Indiana, have preincorporation jurisprudence similar to Oregon's concerning the need to require warnings to protect the privilege against compelled self-incrimination.[237] With the Supreme Court no longer acting as the conscience of the nation,[238] *Smith* stands as a reminder that state courts must choose between retreating to preincorporation case law or employing their state constitutions to maintain decisional consistency with post-incorporation cases.[239] As Justice Linde observed, *State v. Smith* also serves to remind us that, "despite recent progress in many state courts, people in Oregon as elsewhere still need the protection of federal law for the basic liberties common to the national and states' bills of rights."[240]

VI. Practical Applications of State Bill of Rights Provisions

Now that the importance of asserting client rights under the state constitution has been demonstrated, and needed concepts and the building blocks of constructing state constitutional arguments have been set out, it is also important to understand the practical applications of state constitutional protections. Most states have a scarcity of decisions under various constitutional provisions. To frame a persuasive state-based argument, counsel should become aware of and use decisions by sister state courts.[241] To illustrate practical use of state constitutional protections, let us look at how state courts outside Indiana interpret and apply a small sample of state provisions that have analogs in the Indiana Constitution.[242] As we have discussed earlier, counsel should always be aware of whether the state provision he or she intends to rely on has an analog in the federal Constitution.

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[235] *Id.* at 681, 725 P.2d 894 (1986) (distinguishing State v. Sparklin, 296 Or. 85, 672 P.2d 1182 (1983); State v. Mains, 295 Or. 640, 669 P.2d 1112 (1983)).

[236] *Id.* at 701, 725 P.2d at 906.

[237] *See, e.g.*, State v. Campbell, 229 Ind. 198, 96 N.E.2d 876 (1951) (holding that warnings as to right of counsel and right to remain silent must be given by trial court at time of arraignment); Wilson v. State, 222 Ind. 63, 51 N.E.2d 848 (1943) (same).

[238] Mosk, *supra* note 44, at 1087-88.

[239] *Id.*

[240] *Smith*, 301 Or. at 722, 725 P.2d at 914. (Linde, J., dissenting).

[241] *See* Carson, *supra* note 2, at 656-58.

[242] To identify which states have provisions similar to Indiana, see Constitutions of the United States: National and State (F. Grad 2d ed. 1982); B. Sachs, Constitutions of the United States—Fundamental Liberties and Rights, A Fifty State Index (1980);

A. No Federal Analog: Article 1, Section 13 of the Indiana Constitution

Suppose your clients are male inmates at the state penitentiary. They ask you to seek an injunction prohibiting prison officials from assigning female guards to duties that involve frisking male prisoners or observing them while they shower or use the toilets. Assuming that a statutory claim is unavailable, what constitutional interest should you claim was violated? This exact situation arose in the Oregon case of *Sterling v. Cuppy*,[243] where the Oregon Supreme Court reviewed a lower court decision in favor of the inmates, based on the federal "constitutional right to privacy."[244] The Oregon Supreme Court found a federal privacy right to be a difficult premise for decision and turned instead to the Oregon Constitution.[245]

In addition to the state constitution's ban on cruel and unusual punishment, which has a federal analog, the Oregon court noted that the Oregon Constitution establishes penal principles in four provisions, which have no federal analogs.[246] After observing that each of these provisions came out of Indiana's Constitution,[247] the court traced the history of penal reform in the states during the post-revolutionary decades. The court focused on article 1, section 13, because it directly addressed prison practices.[248] Oregon's section 13 is identical to article 1, section 15 of the Indiana Constitution, which provides:

> "No person arrested, or confined in jail, shall be treated with unnecessary rigor."

The Oregon court held that male prisoners had a constitutionally founded objection to searches by female officers under the unnecessary rigor clause, which prohibited such searches unless performance by officers of the opposite sex was compelled by necessity.[249]

W. Swindler, Sources & Documents of United States Constitutions (1979). To keep track of state court interpretations of their own constitutions, Oregon Justice William P. Carson, Jr. suggests the following: (1) West's Key Number 18 Under the Heading "Constitutional Law;" (2) *Developments in the Law—The Interpretations of State Constitutional Rights*, 95 Harv. L. Rev. 1324-1502 (1982); and (3) most importantly, Ron Collins column, *Developments in State Constitutional Law*, published regularly in The National Law Journal. Carson, *supra* note 2, at 658.

[243] 290 Or. 611, 625 P.2d 123 (1981).

[244] Sterling v. Cupp, 44 Or. App. 755, 757, 607 P.2d 206, 207 (1980).

[245] *Sterling*, 290 Or. at 616, 625 P.2d at 127-28.

[246] *Id.* at 616, 675 P.2d at 128 (citing Or. Const. art. 1, §§ 15, 25, 16, 13).

[247] *Id.* at 617, 625 P.2d at 129. *Compare* Or. Const. art. 1, §§ 15, 25, 16 and 13 *with* Ind. Const. art. 1, §§ 18 (penal code founded on reformation, not vindictiveness), 30 (effect of conviction), 16 (excessive bails and fines), and 15 (no unnecessary rigor).

[248] *Sterling*, 290 Or. at 619, 625 P.2d at 130.

[249] *Id.* at 632, 625 P.2d at 136.

To support its conclusion that the unnecessary rigor prohibition goes beyond standards contained in other constitutional sections, and in support of its belief that the unnecessary rigor standard was not confined to physical abuse, the Oregon court quoted the Indiana Supreme Court's explanation of the unnecessary rigor prohibition.[250] Whether the Indiana Constitution provides inmates with the protection sought in *Sterling* remains to be seen. Nevertheless, *Sterling* provides counsel with a strong argument to that effect.

B. Substantive Protection Analogs

1. Equal Protection: Article 1, Sections 1, 12 and 23.—Like most state constitutions, Indiana's Bill of Rights does not contain an "equal protection" clause per se.[251] It does, however, contain a guarantee of equal privileges and immunities,[252] a guarantee of a remedy by due course of law,[253] and a broad guarantee of inalienable rights.[254] The wording of these provisions differs substantially from that of their federal constitutional analogs, yet at one time or another, the Indiana Supreme Court has interpreted each of these provisions as providing protections substantively identical to the equal protection clause of the fourteenth amendment to the United States Constitution.[255] Although recognizing

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[250]*Id.* at 619-20, 625 P.2d at 120-30 (quoting Bonahoon v. State, 203 Ind. 51, 56, 178 N.E. 570, 571 (1931) (upholding a conviction of police officers for assault and battery against a prisoner). For other Indiana cases construing the unnecessary rigor prohibition, see, e.g., Roberts v. State, 159 Ind. App. 456, 307 N.E.2d 501 (1974) (citing the prohibition to support tort recovery for physical abuse); Matovina v. Hult, 125 Ind. App. 236, 123 N.E.2d 893 (1955) (same).

[251]*See* Williams, *Equality Guarantees in State Constitutional Law*, 63 Tex. L. Rev. 1195, 1196 (1985).

[252]"The General Assembly shall not grant to any citizen, or class of citizens, privileges or immunities, which, upon the same terms, shall not equally belong to all citizens." Ind. Const. art. 1, § 23.

[253]"Every man, for injury done him in his person, property, or reputation, shall have remedy by due course of law." Ind. Const. art. 1, § 12.

[254] WE DECLARE, That all men are created equal; that they are endowed by their CREATOR with certain inalienable rights; that among these are life, liberty, and the pursuit of happiness; that all power is inherent in the People; and that all free governments are, and of right ought to be, founded on their authority, and instituted for their peace, safety, and well being.

Ind. Const. art. 1, § 1.

[255]*See, e.g.*, South Bend Pub. Transp. Corp. v. City of South Bend, 428 N.E.2d 217 (Ind. 1981) (art. 1, § 12 contains due process and equal protection guarantees like the fourteenth amendment); Reilly v. Robertson, 266 Ind. 29, 360 N.E.2d 171, *cert. denied*, 434 U.S. 825 (1977) (art. 1, § 23 intended to protect rights identical to those in fourteenth amendment equal protection clause); Department of Ins. v. Schoonover, 225 Ind. 187, 72 N.E.2d 747 (1947) (art. 1, § 1 is similar in meaning and application to fourteenth amendment).

federal equal protection decisions as having only persuasive force,[256] Indiana courts seem to employ the federal suspect class/fundamental right/level of scrutiny approach,[257] and will usually acquiesce in, rather than conflict with, federal decisions.[258]

A recent Indiana Court of Appeals case illustrates the Indiana approach.[259] The plaintiff served as a police officer in a small Indiana community from 1977 until 1982, when she was hired by the South Bend Police Department. However, a state statute forbade hiring police officers after the age of thirty-six, with an exception for those who had previously participated in the state pension plan. Because she was hired after her thirty-sixth birthday and her prior police employer participated in a different pension plan system, state statutes required South Bend to discharge her. The plaintiff invoked the protection of the fourteenth amendment and article 1, section 23 of the Indiana Constitution, bringing an equal protection challenge against the state statute.[260] The court

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[256]City of Indianapolis v. Wright, 267 Ind. 471, 476, 371 N.E.2d 1298, 1300 (1978); *Reilly*, 266 Ind. at 37, 360 N.E.2d at 175; *Schoonover*, 225 Ind. at 194, 72 N.E.2d at 750.

[257]*See, e.g.*, Reed v. United States, 604 F. Supp. 1253 (N.D. Ind. 1984) (same standard of review applies under Indiana's art. 1, § 23 and the fourteenth amendment); *Reilly*, 266 Ind. at 36 n.1, 260 N.E.2d at 175 n.1 (court found rational basis test invalidated use of actuarial tables to determine payments of benefits to retired teachers, making it unnecessary to determine whether United States Supreme Court employs an "intermediate" level of scrutiny in sex-based classifications); Sidle v. Majors, 264 Ind. 206, 210, 341 N.E.2d 763, 767 (1976) (if neither a fundamental right nor a suspect class is involved, standard of review applied by Indiana courts is that the classification not be arbitrary or unreasonable); Sobieralski v. City of South Bend, 479 N.E.2d 98 (Ind. Ct. App. 1985) (finding no fundamental right or suspect class, court applied rational basis standard to uphold age classification for hiring police officers); Scalf v. Berkel, Inc., 448 N.E.2d 1201 (Ind. Ct. App. 1983) (analysis under Indiana case law is applicable to federal equal protection questions).

[258] It is the province of the state courts to interpret and apply the provisions of their state Constitutions, but where a provision of a state Constitution is similar in meaning and application to a provision of the federal Constitution, it is desirable that there should be no conflict between the decisions of the state courts and the federal courts on the subject involved. While a decision of the Supreme Court sustaining the validity of a state statute as not violative of any provision of the Fourteenth Amendment is not absolutely binding on the courts of the state when the statute is attacked as being in conflict with a provision of the state Constitution having the same effect, still, the federal decision in such cases is strongly persuasive authority, and is generally acquiesced in by the state courts.

Wright, 267 Ind. at 476, 371 N.E.2d at 1300-01 (quoting Sperry & Hutchinson Co. v. State, 188 Ind. 173, 180, 122 N.E. 584, 587 (1919)). *See also* Haas v. South Bend Community School Corp., 259 Ind. 515, 289 N.E.2d 495 (1972) (because rights intended to be protected under both constitutional provisions were identical, a violation of the fourteenth amendment necessarily violates art. 1, § 23).

[259]Sobieralski v. City of South Bend, 479 N.E.2d 98 (Ind. Ct. App. 1985).

[260]*Id.* at 99-100.

rejected the challenge by citing the equivalency of the state and federal protections, applying the federal analytic, determining that neither a fundamental right nor a suspect class was involved, and upholding the statute under rational basis scrutiny.[261]

Many states have been willing to break free from the federal approach and the perceived need to conform their results with federal decisions.[262] State equal protection doctrine preceded by two centuries today's federal model, which originated relatively recently in what Professor Robert Williams calls "the Warren Court's brief 'egalitarian revolution.' "[263] Several states with provisions similar to Indiana's have begun to rediscover state constitutional equality guarantees.[264] Under a provision similar to Indiana's article 1, section 23, California independently applies the federal analytic, often reaching conclusions different from federal decisions.[265] Washington also has a similar provision, and we relied upon it to reject the federal intermediate scrutiny for sex classifications, in favor of a strict scrutiny/suspect class approach.[266] Similarly, Oregon modeled its equal privileges guarantee on Indiana's provision and relied on it to develop its own equal protection approach.[267] Under a general equality provision similar to Indiana's article 1, section 1, New Jersey rejected the federal two-tiered analysis and employed a balancing test that considers three factors: the nature of the right affected, the extent of the government's intrusion, and the public need for the restriction.[268]

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[261]*Id.* at 99-101.

[262]Williams, *supra* note 251, at 1197.

[263]*Id.* at 1196. Indiana has long applied a rational basis type scrutiny, but has also required that differences used to classify must be inherent, substantial, germane to the subject and purpose of the legislative classification, and must include all within the class. *See, e.g.*, School of City of Elwood v. State *ex rel.* Griffin, 203 Ind. 626, 180 N.E. 471 (1932), *overruled on other grounds,* McQuaid v. State *ex rel.* Sigler, 211 Ind. 595, 6 N.E.2d 547 (1937); Bolivar Township Bd. of Fin. v. Hawkins, 297 Ind. 171, 191 N.E.2d 158 (1934).

[264]State constitutions with provisions similar to IND. CONST. art. 1, § 23 include: ARIZ. CONST. art. 1, § 13; CAL. CONST. art. 1, § 7; IOWA CONST. art. 1, § 7; N.D. CONST. art. 1, § 20; OR. CONST. art. 1, § 20; S.D. CONST. art. 1, § 18; and WASH. CONST. art. 1, § 12.

[265]*See, e.g.*, Committee to Defend Reproductive Rights v. Meyers, 29 Cal. 3d 252, 257, 625 P.2d 779, 783, 172 Cal. Rptr. 866, 868 (1981) (taking a different view concerning abortion financing); Hardy v. Stumpf, 21 Cal. 3d 1, 7, 576 P.2d 1342, 1344, 145 Cal. Rptr. 176, 178 (1977) (finding sex to be a suspect class).

[266]Hanson v. Hutt, 83 Wash. 2d 195, 201, 517 P.2d 599, 603 (1973) (decided prior to passage of state equal rights amendment, art. 31, § 1).

[267]*See, e.g.*, Hewitt v. State Accident Ins. Fund Corp., 294 Or. 33, 653 P.2d 970 (1982) (adopted federal suspect class analysis and applied it to sex classifications, but rejected other aspects of federal analytic).

[268]Greenberg v. Kimmelman, 99 N.J. 552, 564, 494 A.2d 294, 302 (1985); Right-To-Choose v. Byrne, 91 N.J. 287, 450 A.2d 925 (1982) (under art. 1, part 1 of state constitution, court used a balancing approach to assess competing government and individual interest,

Counsel seeking to frame an innovative and persuasive equal protection argument in Indiana should focus on the basic assumption underlying the present Indiana approach: that the equal privileges and immunities provision was intended to provide the same substantive protection as the fourteenth amendment. However, article 1, section 23 differs in text, origin, and focus from the fourteenth amendment.[269] Inserted into the Indiana Bill of Rights in 1851, the provision probably reflects the "Jacksonian opposition to favoritism and special treatment for the powerful."[270] Acting nine years before the Civil War and seventeen years before the Reconstruction Congress enacted the fourteenth amendment, the Indiana delegates' most likely target was prohibition of special privileges. Thus, the purpose of Indiana's provision probably differed substantially from that of the fourteenth amendment, which was concerned with discrimination against disfavored groups, such as former slaves.[271]

In developing its own equal protection approach, the Oregon Supreme Court reviewed this history and concluded that a historically based distinction exists between state equal privileges and immunities provisions and the fourteenth amendment.[272] The former prevent the enlargement of rights, while the latter forbids curtailment of rights belonging to a group or individual.[273] Of course, the question in Indiana is whether the Indiana Supreme Court will recognize this distinction and use it to develop its own equal protection analytic. The answer depends upon whether, in an appropriate case, counsel makes a well-researched and persuasive argument. As I have pointed out elsewhere, counsel has the responsibility for providing a state supreme court with the opportunity to "scrutinize older state court pronouncements to determine whether they constitute actual holdings and, if not, whether they were based on assumptions that are no longer valid."[274]

2. *The Right to Bear Arms: Article 1, Section 32.*—At first glance, Indiana's right to bear arms guarantee, article 1, section 32, appears to

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and invalidated state statute restricting Medicaid funding); *see also* Carson v. Maurer, 120 N.H. 925, 931-32, 424 A.2d 825, 830-32 (1980) (under N.H. Const. part 1, arts. 2 & 12, court invalidated state restrictions on medical malpractice claims using a reasonable classification and fair-and-substantial-relation style of analysis).

[269] *See* Williams, *supra* note 251, at 1208.

[270] *Id.* at 1207. Unlike drafters of earlier state constitutions, the 1851 delegates demonstrated their commitment to equality by outlawing slavery and involuntary servitude. Ind. Const. art. 1, § 37. *See* Williams, *supra* note 242, at 1205 (questioning commitment to equality of those who allowed slavery to continue).

[271] *See* Linde, *Without "Due Process:" Unconstitutional Law in Oregon*, 49 Or. L. Rev. 125, 182-83 (1970).

[272] Hewitt v. State Accident Ins. Fund Corp., 294 Or. 33, 42, 653 P.2d 970, 975 (1982).

[273] *Id.*

[274] Utter, *supra* note 6, at 507.

provide a guarantee substantively identical to the second amendment right.[275] However, because article 1, section 32 contains the phrase "for the defense of themselves and the State," and the second amendment does not, the state provision appears to provide a broader protection. A case now wending its way through Indiana's appellate process provides an excellent illustration of the significance of this textual difference.

In *Kellogg v. City of Gary*,[276] citizens of Gary, Indiana, sought a state court injunction and damages from city officials for an alleged violation of their right to bear arms. In an effort to control the number of handguns on the streets of Gary, the Mayor of Gary and the Chief of Police had adopted a policy of no longer distributing handgun permit applications from the Chief's office.[277] The plaintiffs claimed this policy violated their right to bear arms because, under state statute, citizens of Gary could not obtain the application forms elsewhere.[278] The trial court and the jury agreed.[279] Although the city's appeal of the jury's damage award raises a number of interesting issues,[280] what concerns us here are the state and federal right to bear arms arguments.

The facts of *Kellogg* highlight the narrowness of the second amendment's effect and scope. Because the federal Bill of Rights does not apply in and of itself to the states, the second amendment may not offer Gary citizens any protection at all.[281] In *Quilici v. Village of Morton Grove*,[282] the Seventh Circuit concluded that the second amend-

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[275]Ind. Const. art. 1, § 32 provides that "[t]he people shall have the right to bear arms; for the defense of themselves and the State." U.S. Const. amend. II provides that "[a] well regulated militia being necessary to the security of a free State, the right of the people to keep and bear Arms, shall not be infringed."

[276]No. 380-163 (Lake Superior Court, Civ. Div., April 6, 1983).

[277]Motley v. Kellogg, 409 N.E.2d 1207, 1209 (Ind. Ct. App. 1980).

[278]*Id.* at 1208-09.

[279]Initially the trial court issued a preliminary injunction in the plaintiffs' favor, which was affirmed on appeal. *Id.* After the initial appeal, a jury verdict awarded the plaintiffs over $200,000 in compensatory damages and $440,000 in punitive damages. Brief for Appellant at 5-10, City of Gary v. Kellogg, No. 3-983 A291 (Ind. Ct. App. filed Sept. 10, 1983).

[280]The City's appeal of the damage award has not yet been decided. City of Gary v. Kellogg, No. 3-983 A291 (Ind. Ct. App. filed Sept. 10, 1983). Issues awaiting resolution include: whether a 28 U.S.C. § 1983 suit lies for a violation of a state right; whether any federal right was violated; whether the Indiana Tort Claims Act recognizes an action of this type; and whether the defendants have absolute or qualified immunity from suit. Brief for Appellants at 2-5.

[281]Although the Supreme Court has not recently ruled on the issue, several older cases cast serious doubt on whether the Court will incorporate the federal right to bear arms as a fourteenth amendment due process requirement. *See* Presser v. Illinois, 116 U.S. 252, 265 (1886) (holding that the second amendment applied only to actions by the federal government); United States v. Cruikshank, 92 U.S. 542, 553 (1875).

[282]695 F.2d 261 (7th Cir. 1982).

ment does not affect city ordinances regulating or even prohibiting handgun ownership.[283] Even if the federal guarantee applies, the Supreme Court has held that the second amendment embraces only those arms necessary to maintain a well regulated militia.[284] This conclusion led the Seventh Circuit to reject a claim similar to that in *Kellogg*, and to hold that the second amendment does not guarantee the right to keep and bear handguns.[285]

Because Indiana's provision explicitly recognizes an individual right to bear arms, the *Kellogg* plaintiffs have a greater chance of prevailing under the state constitution.[286] In *State v. Kessler*,[287] the Oregon Supreme Court relied on Oregon's right to bear arms, which is identical to Indiana's,[288] and invalidated a statute that made possession of a "slugging weapon" a criminal offense.[289] After tracing the history and underlying rationale of Indiana's right to bear arms provision, the Oregon court concluded that unlike the federal analog, the state provision provided an individual the right to possess arms for personal defense.[290] In *Kellogg*, counsel on both sides rely on Oregon's analysis in *Kessler*. In their briefs, counsel for both parties have framed excellent state constitutional arguments in support of their positions, making good use of each building block discussed earlier in this Article.[291] How the Indiana courts decide

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[283]*Id.* at 270.

[284]United States v. Miller, 307 U.S. 174, 178 (1938); *see* Lewis v. United States, 445 U.S. 55 (1980) (citing the *Miller* holding with approval).

[285]*Quilici*, 695 F.2d at 270-71 (holding that a Morton Grove, Illinois, ordinance prohibiting the possession of handguns did not violate the Illinois or the federal Constitutions).

[286]Plaintiffs obviously reached the same conclusion because up until this latest appeal, they explicitly based their right-to-bear arms claim on the Indiana Constitution, rather than on the second amendment. Amicus Curiae Brief of National Rifle Association & Indiana Sportmen's Council at 70, City of Gary v. Kellogg (Ind. Ct. App. filed Sept. 10, 1983) (No. 3-983 A291). Nonetheless, plaintiffs argued on appeal that if presented with the issue, the United States Supreme Court would be "compelled" to incorporate the second amendment into the fourteenth and hold that the city policy violated federally guaranteed rights. *Id.* at 71-80.

[287]289 Or. 359, 614 P.2d 94 (1980).

[288]Oregon's guarantee combines Indiana's art. 1, §§ 32 and 33 into one section, providing that "[t]he people shall have the right to bear arms for the defense of themselves, and the State, but the Military shall be kept in strict subordination to the civil power." Or. Const. art. 1, § 27; Ind. Const. art. 1, §§ 32, 33.

[289]*Kessler*, 289 Or. at 369, 614 P.2d at 99-100.

[290]However, this is not an unrestricted right to carry or use personal weapons in all circumstances. *Id.* at 369, 614 P.2d at 95-99.

[291]*See* Amicus Curiae Brief for National Rifle Association & Indiana Sportmen's Council at 6-29, City of Gary v. Kellogg (Ind. Ct. App. filed Sept. 10, 1983) (No. 3-983 A291). Appellants at A1-11, City of Gary v. Kellogg (Ind. Ct. App. filed Sept. 10, 1983) (No. 3-983 A291).

Kellogg may have far reaching effects both inside and outside Indiana.[292] Yet, regardless of which party prevails, *Kellogg* vividly demonstrates that state constitutional provisions, even those with substantive federal analogs, offer counsel and courts the opportunity to develop independent state constitutional law.

C. Textual Analogs: Article 1, Section 11

As noted earlier, framing a persuasive independent state argument becomes most difficult when the state provision contains text identical to its federal analog. Due to the great number of criminal law cases and the similarity between state and federal constitutional protections for those accused of a crime, criminal law cases have become "the crucible where the development of a body of state constitutional law is most heatedly disputed and resisted."[293] Perhaps the most public and most controversial are the state and federal protections against unreasonable search and seizure. Like Indiana's article 1, section 11, many state search and seizure provisions contain language identical to the federal fourth amendment.[294] Regardless of whether a state provision employs identical text, state courts have equal responsibility for independently interpreting their state constitutions. Resort to some simple fact patterns provides an opportunity to compare the approaches adopted by various state courts.

Suppose the police get an anonymous tip that a certain individual is involved in drug trafficking. Based on this tip, the police approach the phone company, which agrees to place a pen register (a device that records the numbers dialed) on the phone and to turn over the suspect's long distance call records. As a result of information gleaned from the phone records, the police arrest the suspected individual, who moves at the beginning of his trial to suppress the pen register and toll call records. What result?

Under the federal Constitution the suppression motion would be denied. In *Smith v. Maryland*,[295] the Supreme Court held that the fourth amendment does not prohibit installation of pen registers on personal

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[292]Plaintiffs argued that the Indiana right to bear arms is a fundamental right, the infringement of which is actionable under both the remedy guaranty in Ind. Const. art 1, § 12 and 28 U.S.C. § 1983. *See* Amicus Curiae Brief of National Rifle Association & Indiana Sportmen's Council at 36, City of Gary v. Kellogg, No. 3-983 A291 (Ind. Ct. App. filed Sept. 10, 1983); Brief of Appellees at 29-31, 65, City of Gary v. Kellogg, No. 3-983 A291 (Ind. Ct. App. filed Sept. 10, 1983). If Indiana courts agree, state constitutional rights litigation will increase significantly.

[293]Abrahamson, *supra* note 26, at 1144.

[294]*See e.g.*, Ark. Const. art. II, § 15; Mont. Const. art. III, § 7; N.D. Const. art. I, § 18; W. Va. Const. art. III, § 6; Wis. Const. art. III, § 11.

[295]442 U.S. 735 (1979).

telephone lines without a warrant or court order.[296] The Court's rationale emphasized that telephone users voluntarily convey phone numbers to the phone company and therefore no longer have any legitimate expectation of privacy in the information.[297] While no case has provided the right opportunity, the Indiana Supreme Court has indicated that it agrees with the federal "no expectation of privacy" rationale.[298]

One rather doubts that the framers of any of the state constitutions intended to tie the state guarantee against unreasonable search and seizure to a federal analytic developed a century later. Even if we accept that to be the case, the framers would certainly expect a state court to make its own independent determination of the inherently subjective choice involved in deciding whether an individual has a legitimate expectation of privacy which society is willing to recognize. Several state courts have rejected the Supreme Court's subjective choice, for one of their own choosing. For example, in *People v. Sporleder*,[299] the Colorado Supreme Court expressed its conviction that "merely because the telephone subscriber has surrendered some degree of privacy for a limited purpose to those with whom she is doing business does not render the subscriber 'fair game for unrestrained police scrutiny' by virtue of that fact."[300] The court did not reach its conclusion on the basis of different constitutional text; Colorado's article II, section 7 is "substantially similar" to the fourth amendment.[301] Rather, after finding the Supreme Court's reasoning unpersuasive,[302] the Colorado court fulfilled its responsibility by acting on its own well-reasoned conclusion.

Often, conformity of state and federal decisions in the search and seizure area results from a perceived need for uniformity in the criminal enforcement arena.[303] The need for conformity rationale does have some merit.[304] The Oregon Supreme Court, which has a reputation for in-

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[296] *Id.* at 742.

[297] *Id.* at 742-43.

[298] *In re* Order for Indiana Bell Tel. Co. to Disclose Records, 274 Ind. 131, 133, 409 N.E.2d 1089, 1090 (1980) (quoting *Smith* with approval in rejecting Phone Company's first amendment challenge to a subpeona duces tecum, ordering it to turn over long distance phone records to the police).

[299] 666 P.2d 135 (Colo. 1983).

[300] *Id.* at 142 (quoting 1 W. LaFave, Search and Seizure: A Treatise on the Fourth Amendment § 2.7, at 408 (1978)).

[301] *Id.*

[302] *Id.* at 142-43 n.6. The Colorado court noted the Indiana case on the issue, but found its reasoning equally unpersuasive. *Id.*

[303] *See, e.g.*, People v. Corr, 682 P.2d 20, 33 (Colo. 1984) (Erickson, C.J., dissenting) *cert. denied*, 469 U.S. 855 (1984) (need for state officers to be able to rely on federal interpretations in criminal area); State v. Ringer, 100 Wash. 2d 688, 703, 674 P.2d 1240, 1250 (1983) (Dimmick, J., dissenting) (independent interpretation in criminal area will confound the police); Maltz, *supra* note 107, at 1005; Simon, *supra* note 57, at 318-19 & n.113.

[304] *See* Comment, *supra* note 32, at 518-19 n.72.

dependent decisionmaking, believes that a uniform set of simple *Miranda*-style warnings is required.[305] Nevertheless, the very nature of federalism means that the scope of individual rights will vary from state to state. As the New York Court of Appeals recently observed, "[t]he interest of Federal-State uniformity, however, is simply one consideration to be balanced against other considerations that may argue for a different state rule. When weighed against the ability to protect fundamental constitutional rights, the practical need for uniformity can seldom be a decisive factor."[306] Comparison of the recent application of federal and state exclusionary rules illustrates New York's point.

Let us assume that your client has been arrested as a result of evidence discovered pursuant to a search under warrant. A neutral magistrate issued the warrant based on a police officer's affidavit that included the following: for unknown reasons, a police informant concluded your client dealt drugs; a person previously arrested for drug possession was seen at your client's gas station; after viewing unspecified suspicious activity at the station, a detective, with an unknown level of expertise and experience, concludes that your client is dealing drugs. At trial you move to suppress the evidence. The trial court finds the warrant issued without probable cause, but refuses to suppress because the police officer acted in objectively reasonable belief that the warrant was valid. You appeal. What result?[307]

Under the fourth amendment, the evidence need not be suppressed. This fact pattern fits squarely into the Supreme Court's good faith exception adopted in *United States v. Leon*.[308] The Court's rationale for creating the good faith exception was that the only purpose of the exclusionary rule, deterrence of police misconduct, cannot be served by excluding evidence when officers have a good faith belief in the constitutionality of their actions.[309] Under state law, results will differ. Arizona, for example, often follows an independent path in construing the scope of its search and seizure rule. It adopted the good faith exception, however, because it believed that "one of the few things worse than a single exclusionary rule is two different exclusionary rules."[310] Here in Indiana, the court of appeals explicitly adopted the good faith

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[305]State v. Sparklin, 296 Or. 85, 672 P.2d 1182, 1184 (1983) (refusing to adopt different warnings under state constitution).

[306]People v. P.J. Video, Inc., 68 N.Y.2d 296, 501 N.E.2d 556, 508 N.Y.S.2d 907 (1986).

[307]This identical fact pattern occurred in a recent New Jersey case, in which the court refused to adopt the good faith exception under the state constitution. State v. Novembrino, 105 N.J. 95, 519 A.2d 820 (1987).

[308]468 U.S. 897 (1984).

[309]*Id.* at 906-08.

[310]State v. Bolt, 142 Ariz. 260, 268, 689 P.2d 519, 527 (1984).

exception on the grounds that the Indiana rule has historical ties to its federal counterpart, the identity of constitutional text, and no compelling reason existed to reject *Leon*.[311] Although the Indiana Supreme Court has applied the exception in dicta, it did so in the fourth amendment context because the defendant did not raise or argue the state constitutional issue.[312] As a result, the good faith issue remains open in Indiana.

Counsel preparing to challenge the exception on state constitutional grounds will find the approach adopted in Washington and New Jersey applicable to the Indiana experience. Both Indiana and Washington adopted state exclusionary rules[313] six decades before the Supreme Court applied the federal rule against the states in *Mapp v. Ohio*.[314] In *State v. White*,[315] the Washington Supreme Court rejected the good faith concept and the deterrence rationale on which it is based. We found them inconsistent with the state constitution's broad privacy protection, with over forty years worth of independent state exclusionary rule jurisprudence, and with federal exclusionary rule jurisprudence.[316] While Indiana's article 1, section 11 text differs substantially from Washington's privacy protection, Indiana's independent exclusionary rule jurisprudence reflects the same influences as Washington's[317] and provides persuasive support for counsel's argument. For example, how does one square a good faith exception with the Indiana Supreme Court's stated belief that "[i]f the search warrant under which . . . officers searched [a defendant's] premises is invalid for any reason, the evidence must be excluded."[318] Review of Indiana's exclusionary rule development may lead counsel and the courts to reach the same conclusion as the Oregon and Washington Supreme Courts: the state exclusionary rule's essential purpose is to protect personal constitutional rights by affording a remedy for the

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[311]Mers v. State, 482 N.E.2d 778, 783 (Ind. Ct. App. 1985).

[312]Blalock v. State, 483 N.E.2d 439, 444 (Ind. 1985) (court held that affidavit was sufficient to establish probable cause under fourth amendment, but remarked in dicta that the *Leon* good faith exception would render the evidence seized admissible).

[313]*See* Callender v. State, 193 Ind. 91, 138 N.E.2d 817 (1922); State v. Gibbons, 118 Wash. 171, 203 P. 390 (1922).

[314]367 U.S. 643 (1961).

[315]97 Wash. 2d 92, 640 P.2d 1061 (1982).

[316]*Id.* at 110-12, 640 P.2d 1071-72.

[317]For an in depth discussion of Washington's independent exclusionary rule, see Comment, *supra* note 77. Indiana case law parallels Washington's. *Compare* the cases cited in *id. with* Bumen v. State, 203 Ind. 237, 179 N.E. 716 (1932); Mata v. State, 203 Ind. 291, 179 N.E. 916 (1932); Wallace v. State, 199 Ind. 317, 157 N.E. 657 (1927); Flum v. State, 193 Ind. 585, 141 N.E. 353 (1923); Callender v. State, 193 Ind. 91, 138 N.E. 817 (1923).

[318]Bumen v. State, 203 Ind. 237, 239, 179 N.E. 716, 717 (1932). Another interesting question would be if an officer's good faith provides immunity to a tort action, then does not the good faith exception deprive the defendant of all possible remedies for the violation of his rights in derogation of Ind. Const. art. 1, § 12.

violation of those rights, the protection of which may result in deterrence, but only as an incidental by-product.[319]

As for other compelling reasons to reject the good faith exception, the New Jersey Supreme Court's decision in *State v. Novembrino*[320] offers counsel a host of persuasive arguments. Even though New Jersey had no state exclusionary rule prior to *Mapp*, the New Jersey Supreme Court relied on the state constitution because twenty-five years of exclusionary rule application imbedded the rule in state constitutional jurisprudence.[321] In addition, the court concluded that the *Leon* decision will undermine police motivation to comply with the constitutional requirement of probable cause.[322] The state interest in preventing the ultimate reduction in respect for, and compliance with, the probable cause standard outweighed the perceived need to maintain federal-state uniformity with regard to the exclusionary rule.[323]

The criminal law offers state courts greater opportunity to decide both state and federal constitutional issues. While several other state courts have agreed with Colorado's rejection of the *Smith v. Maryland* pen register rule,[324] others adopt the federal approach.[325] State courts have divided over the appropriateness of the *Leon* good faith exception.[326] The issue, of course, is not the particular result reached. Rather, state courts should be judged on whether they have created a principled body of state law based on their own independent analysis and interpretation. The importance of counsel's role in the creation of that body of law cannot be overstated.

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[319]State v. Davis, 295 Or. 227, 235, 666 P.2d 802, 806-07 (1983); State v. White, 97 Wash. 2d 92, 108-12, 640 P.2d 1061, 1070-72 (1982); Comment, *supra* note 77, at 496-515.

[320]105 N.J. 95, 519 A.2d 820 (1987).

[321]519 A.2d at 856.

[322]519 A.2d at 854 (citing 1 W. LaFave, Search and Seizure, § 1.2, at 20 (1986 Pocket Part)).

[323]*Id.*

[324]*See, e.g.*, State v. Hunt, 91 N.J. 338, 450 A.2d 952 (1982); State v. Gunwall, 106 Wash. 2d 54, 720 P.2d 808 (1986).

[325]*See, e.g.*, Hasteter v. Behan, 196 Mont. 280, 639 P.2d 510 (1982); People v. Guerra, 116 Misc. 2d 272, 455 N.Y.S.2d 713 (N.Y. Sup. Ct. 1982).

[326]Examples of courts choosing to follow *Leon* include: McFarland v. State, 284 Ark. 533, 684 S.W.2d 233 (1985); State v. Sweeney, 701 S.W.2d 420 (Mo. 1985) (dictum); State v. Welch, 316 N.C. 578, 342 S.E.2d 789 (1986); McCary v. Commonwealth, 228 Va. 219, 321 S.E.2d 637 (1984). Courts rejecting the *Leon* approach include: Commonwealth v. Upton, 394 Mass. 363, 476 N.E.2d 548 (1985); People v. Sundling, 153 Mich. App. 277, 395 N.W.2d 306 (1986); People v. Bigelow, 66 N.Y.2d 417, 488 N.E.2d 548, 497 N.Y.S.2d 630 (1985); State v. Grawien, 123 Wis. 2d 428, 367 N.W.2d 816 (Ct. App. 1985). *See also* Stringer v. State, 491 So. 2d 837 (Miss. 1985) (Robertson, J., concurring).

VII. Conclusion

The structural integrity of our federal system depends upon state constitutions and state courts providing an independent guaranty of individual rights. While the system's state constitutional component was in danger of being overwhelmed by its national counterpart, the danger has subsided with the recent rediscovery of the rich heritage and unique protections offered by our state constitutions. The trend towards development of a principled body of state constitutional law needs nurturing if it is to continue to spread and mature. Each component of a state's legal system—state bar, law schools, and judiciary—bears a measure of responsibility for breathing life into a state constitution.

Practitioners, students, and law faculty each have a unique role to play in the rebirthing process. Due to the low level of state civil rights litigation, especially here in the Midwest, counsel must assume the role of catalyst, presenting well-researched and persuasive arguments on behalf of state constitutional protection for their client's rights. Law students and faculty must also serve as catalysts by fostering change in the content of our constitutional law and individual rights courses to include significant discussion of the history, scope, and meaning of their state constitution. Better academic preparation will assist lawyers in meeting their responsibility to familiarize themselves with the techniques being developed to frame persuasive state constitutional arguments.

Once presented with a squarely-raised and well-argued state constitutional claim, state judges become the key actors in the rebirthing process. They must acknowledge their power to independently interpret and apply their state constitutions. Having done so, state courts will develop a principled decisionmaking process for interpreting the historical mandates contained in their state bill of rights. Explanations will then be offered for why a state court finds the United States Supreme Court's interpretations of federal analogs persuasive or unconvincing and how the state courts will treat future variations in federal doctrine. Once a state court begins to develop an independent jurisprudence, practitioners, students, and faculty must provide scholarly analysis and commentary, which should closely scrutinize the court's interpretations of the state constitution.

As lawyers, students, and faculty take their roles seriously, each can significantly influence the direction and development of a principled body of state constitutional jurisprudence. Limitless opportunities exist for reevaluating the validity of old assumptions and for developing new analytics to solve the difficult constitutional problems facing state courts.

Notes

The Safe-Harbor Interest Rates Under Section 483 of the Internal Revenue Code: A Gift Tax Trap

I. Introduction

The use of an inappropriate interest rate on certain deferred sales transactions can create unforeseen gift tax consequences for related parties. Where one party sells property to a related party and the purchase price of the property is to be paid in installments, the relevant concern is the interest rate used to calculate the installment payments. Two interest rates are possible: one is the market interest rate; the other is the interest rate provided by section 483[1] of the Internal Revenue Code of 1954 (Code), which applies to certain deferred sales transactions similar to the one described above.[2] If the parties use the lower of the two interest rates, which presumably is the section 483 interest rate, then the Internal Revenue Service (IRS) might assert, as it did in *Ballard v. Commissioner*,[3] that a taxable gift has been made based on the difference between the market interest rate and the section 483 interest rate.

Section 483, enacted as part of the Revenue Act of 1964,[4] applies to certain sales or exchanges of real or personal property in which the purchase price of the property is to be paid in installments.[5] Section 483 imputes a certain rate of interest to such deferred sales transactions in which the parties do not charge at least the interest rate specified by section 483.[6] The rate of interest imputed under section 483 is unquestionably imputed for income tax purposes to ensure that the seller will recognize (pay income tax on) an appropriate amount of interest income.[7]

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[1]All section numbers used in this Note refer to the Internal Revenue Code of 1954 as amended.

[2]*See* I.R.C. § 483 (Supp. III 1985).

[3]53 T.C.M. (CCH) 323 (1987). *See infra* text accompanying notes 42-55.

[4]Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19, 77-78; *see also* H.R. Rep. No. 749, 88th Cong., 2d Sess. 1, 72, *reprinted in* 1964 U.S. Code Cong. & Admin. News 1313, 1380 [hereinafter H.R. Rep. No. 749]; S. Rep. No. 830, 88th Cong., 2d Sess. 1, 101, *reprinted in* 1964 U.S. Code Cong. & Admin. News 1673, 1774 [hereinafter S. Rep. No. 830].

[5]I.R.C. § 483(c) (Supp. III 1985).

[6]*Id.* § 483(a)-(b).

[7]H.R. Rep. No. 749, *supra* note 4, at 1380; S. Rep. No. 830, *supra* note 4, at 1774-75.

The controversy surrounding section 483 is whether, for gift tax purposes, interest is imputed using section 483 interest rates or potentially higher market interest rates such that the seller is deemed to have made a taxable gift if he does not charge at least the *market* rate of interest. For example, a seller of property falling within the scope of section 483 may charge the appropriate rate of interest under section 483 for income tax purposes, but be deemed to have made a taxable gift for gift tax purposes based on the difference between the rate he charged under section 483 and the higher market rate of interest.[8] Therefore, if a transaction falls within the scope of section 483, and the seller charges the appropriate section 483 rate of interest, the seller will not have any income tax problems but may unexpectedly be faced with gift tax problems.

This Note will address the issue of whether the interest rate imputed under section 483 for income tax purposes is also the appropriate rate to impute for gift tax purposes where section 483 applies to a transaction. This Note will also examine the evolution of section 483 as it relates to the discrepancy between section 483 interest rates and market interest rates.[9]

II. Section 483—How It Operates

Section 483 requires that a deferred sale of property transaction include an appropriate amount of interest so that the seller of the property will recognize interest income instead of capital gain income.[10] Congress did not see any reason why taxpayers should not report amounts as interest income merely because they did not contractually provide for it in the contract.[11] For example, suppose the taxpayer sells an asset with a basis and fair market value of $1000 for $1300 payable over ten years with no interest. Over the ten year period, the taxpayer would report $300 [$1300-$1000] of capital gain income. If the taxpayer had sold the asset for its fair market value and had charged interest of $300, the taxpayer would have recognized $300 of ordinary interest income and no capital gain.[12]

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[8]*See infra* text accompanying notes 36-41.

[9]Consequently, this Note will not discuss the original issue discount (OID) rules or section 7872 in any great detail. *See infra* text accompanying notes 194-206.

[10]H.R. Rep. No. 749, *supra* note 4, at 1381; S. Rep. No. 830, *supra* note 4, at 1775; 5 Fed. Taxes (P-H) ¶ 20,921 (1987). *See infra* note 70.

[11]H.R. Rep. No. 749, *supra* note 4, at 1381; S. Rep. No. 830, *supra* note 4, at 1775.

[12]H.R. Rep. No. 749, *supra* note 4, at 1380; S. Rep. No. 830, *supra* note 4, at 1774-75.

Section 483(a)[13] states that a portion of the amount of interest, which should have been specified in the contract but was not, will be allocated to each payment under a contract for the sale or exchange of property. Section 483(b)[14] provides the method for calculating unstated interest, which is the total amount of interest that should have been specified in the contract but was not. Section 483(b) states that the sum of the payments that are due under the contract (not including interest payments) less the present value[15] of all payments due under the contract (including interest payments) equals the total unstated interest.[16] Section 483(c)[17] specifies the payments to which section 483 applies: any payment

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[13]I.R.C. § 483(a) (Supp. III 1985) provides:

§ 483. Interest on certain deferred payments

(a) Amount constituting interest

For purposes of this title, in the case of any payment—

(1) under any contract for the sale or exchange of any property, and

(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

[14]*Id.* § 483(b) provides:

(b) Total unstated interest

For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b)(2) using a discount rate equal to the applicable Federal rate determined under section 1274(d).

[15]The present value of an annuity of $1 per period for n periods is determined by the formula:

$$\frac{1 - \dfrac{1}{(1 + k)^n}}{k}$$

where n = number of periods, and k = interest rate. L. LIPKIN, I. FEINSTEIN & L. DERRICK, ACCOUNTANT'S HANDBOOK OF FORMULAS AND TABLES 16 (P-H 2d ed. 1973).

[16]*See* Treas. Reg. § 1.483-1(c) (as amended in 1981); *see also* Carlson, *Income Tax Blue Law: Imputation of Interest Under Section 483*, 34 TAX L. REV. 187, 188 (1979).

[17]I.R.C. § 483(c) (Supp. III 1985), which provides in relevant part:

(c) Payments to which subsection (a) applies

(1) In general

Except as provided in subsection (d), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

under a contract for the sale or exchange of property where the payment is due more than six months later, where at least some payments under the contract are due more than a year later, and where there is unstated interest.[18]

Example 1.—The contract sales price is $6000 with a payment of $2000 to be received by the seller at the end of each year for three years with no interest. Assume interest under section 483 is to be imputed at a rate of six percent compounded annually. The total payment due under the contract is $6000. The present value of all payments made under the contract at six percent interest would be $2000 × 2.6730[19] = $5346. Total unstated interest would therefore be computed as follows:

Total payments	$6000
Less:	
Present value	$5346
Total unstated interest[20]	$654

Thus, for income tax purposes, the total principal payments would be $5346 and the total interest payments would be $654.[21] Instead of recognizing no ordinary interest income, the seller would recognize $654 of ordinary interest income in accordance with section 483.[22]

Example 2.—The contract sales price is $6000 with a payment of $2245 to be received by the seller at the end of each year for three years or a total of $6735. The payments are computed using a six percent interest rate compounded annually. Thus, $6000 would be principal and $735 would be "stated interest." Assuming that the section 483 interest rate is six percent compounded annually, unstated interest would be computed as follows:

Total payments	$6000
Less:	
Present value [$2245 × 2.6730 =]	$6000
Total unstated interest[23]	$0

(A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and

(B) under which there is total unstated interest.

(2) Treatment of other debt instruments

For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

[18]*Id.*

[19]The present value of an annuity of $1 at the end of a year for three years using a six percent interest rate is $2.6730. *See supra* note 15.

[20]I.R.C. § 483(b) (Supp. III 1985).

[21]*Id.* § 483(a).

[22]*Id.*

[23]*Id.* § 483(b).

Hence, in this example, section 483 would impute no additional ordinary interest income to the seller.[24]

Example 3.—The same facts as in Example 2 apply except that the section 483 imputed rate is nine percent compounded annually, and only a six percent interest rate compounded annually is used to compute payments. Unstated interest would be computed as follows:

Total payments	$6000
Less:	
Present value [$2245 × 2.5313[25] =]	$5683
Total unstated interest[26]	$317

Therefore, unstated interest would be $317,[27] stated interest would be $735, and principal payments would be $5683, for a total payment of principal and interest of $6735. The seller would recognize an additional $317 of ordinary interest income as a result of the application of section 483.[28]

III. Gift Tax Problems

A. Gift Transactions

Generally, a federal gift tax is imposed on all direct or indirect gift transfers.[29] When property is transferred for less than a full and adequate consideration in money or money's worth, the difference between the fair market value of the property and the value of the consideration will be subject to gift taxation.[30] However, the regulations prescribed by the Secretary of the Treasury provide that "a sale, exchange, or other transfer of property if made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."[31] Therefore, if an insubstantial interest rate is charged on a deferred sales transaction, the transaction will be subject to gift taxation because there will be less than a full and adequate consideration received, unless the transaction is determined to have been "made in the ordinary course of business."[32] The question of how substantial an interest rate must be is therefore of prime importance.

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[24]*Id.* § 483(a).

[25]The present value of an annuity of $1 at the end of a year for three years using a nine percent interest rate is $2.5313. *See supra* note 15.

[26]I.R.C. § 483(b) (Supp. III 1985).

[27]*Id.*

[28]*Id.* § 483(a).

[29]I.R.C. § 2511(a) (1982).

[30]*Id.* § 2512(b); Treas. Reg. § 25.2512-8 (1958).

[31]Treas. Reg. § 25.2512-8 (1958).

[32]*Id.*

The Internal Revenue Service and courts generally presume that a transfer of property for less than fair market value made between closely related parties involves a gift;[33] where the parties are unrelated, however, generally no gift is found.[34] Courts also usually find that unrelated party transactions are "made in the ordinary course of business" and not subject to gift taxation.[35] Therefore, gift tax problems arise most often only if the parties are related and will probably not arise where unrelated parties enter into deferred sales transactions under section 483.

Example 4.—The contract sales price and fair market value of property transferred by the seller is $6000 with a payment of $2245 to be received by the seller at the end of each year for three years or a total of $6735. The payments are computed using a six percent interest rate compounded annually. Thus, $6000 would be principal and $735 would be "stated interest." Assume that the section 483 interest rate is six percent and the market interest rate is nine percent both compounded annually. As in Example 2, unstated interest under section 483 would be zero, and section 483 would impute no additional ordinary interest income to the seller.[36] If section 483 interest rates are used to value the consideration received by the seller for gift tax purposes,[37] the gift would be computed as follows:

Fair market value of property	$6000
Less:	
Value of consideration discounted using a six percent interest rate [$2245 × 2.6730[38] =]	$6000
Value of gift[39]	$0

[33]*See, e.g.*, Heringer v. Commissioner, 235 F.2d 149, 151 (9th Cir. 1956) (the family context of a transfer of property without consideration by family members to a 100% family owned corporation created a presumption of a gift); Estate of Reynolds v. Commissioner, 55 T.C. 172, 201 (1970) (presumption that a transfer of units in a voting trust to family members in exchange for promissory notes is a gift).

[34]*See, e.g.*, Weller v. Commissioner, 38 T.C. 790 (1962) (sale of a 2% interest in a partnership to an unrelated person for less than fair market value did not constitute a taxable gift); Estate of Anderson v. Commissioner, 8 T.C. 706 (1947) (value of stock transferred to unrelated parties was greater than consideration received, but transfers were made in the ordinary course of business and not subject to gift taxation).

[35]*See Weller*, 38 T.C. at 806.

[36]*See supra* text accompanying notes 23-24.

[37]*See* Joyce & Del Cotto, *Interest-Free Loans: The Odyssey of a Misnomer*, 35 Tax L. Rev. 459, 463 (1980) (no reason exists why section 483 would not apply where *A* intends to make a gift to *B* of a portion of the goods transferred; unstated interest under section 483 is also the amount of the gift).

[38]*See supra* note 19.

[39]I.R.C. § 2512(b) (1982); Treas. Reg. § 25.2512-8 (1958).

However, if market interest rates are used to value the consideration received by the seller for gift tax purposes, the gift would be computed as follows:

Fair market value of property	$6000
Less:	
Value of consideration discounted using a nine percent interest rate [$2245 × 2.5313[40] =]	$5683
Value of gift[41]	$317

Thus, even if the section 483 interest rate is used to calculate the payments to be received by the seller, a taxable gift will be computed if a higher market interest rate should have been used to value the consideration received by the seller for gift tax purposes.

B. Ballard v. Commissioner

Ballard v. Commissioner,[42] a recently decided United States Tax Court case, illustrates the inequities that result when section 483 applies to a transaction and when market interest rates are used to compute a taxable gift because related parties are involved. In *Ballard*, the taxpayer sold her farm to her three children in June 1981 under a deferred sales contract where the principal amount of the payments was $386,000. The rate used to discount the payments was six percent simple interest, the minimum or "safe-harbor" rate[43] prescribed by section 483 in June 1981.[44] Because the present value of the payments using a six percent interest rate was also $386,000, there was no unstated interest and no additional interest income to recognize.[45]

The taxpayer, who relied upon the section 483 rate for gift tax purposes as well as income tax purposes, contended that the six percent rate under section 483 should be applicable for gift tax purposes as well as income tax purposes.[46] In structuring the transaction, the taxpayer made the following calculation:

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[40]*See supra* note 25.

[41]I.R.C. § 2512(b) (1982); Treas. Reg. § 25.2512-8 (1958).

[42]53 T.C.M. (CCH) 323 (1987).

[43]The phrase "safe-harbor" rate refers to the lowest interest rate that can be used in structuring a deferred sales transaction without section 483 imputing a higher rate.

[44]Treas. Reg. § 1.483-1(d)(1)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135).

[45]I.R.C. § 483(b) (1976).

[46]*Ballard*, 53 T.C.M. (CCH) at 324.

Fair market value of farm	$570,000[47]
Less:	
Value of consideration discounted using a six percent interest rate	$386,000[48]
Value of gift[49]	$184,000

The taxpayer filed a gift tax return, but calculated that she owed no gift tax after available credits and exclusions.[50]

The IRS contended that for gift tax purposes, the taxpayer should have used the market interest rate on the date of transfer—eighteen percent.[51] The present value of the payments due under the contract discounted at an eighteen percent rate was not $386,000, but approximately $134,000.[52] As a result, the IRS calculated the value of the gift as follows:

Fair market value of farm	$570,000
Less:	
Value of consideration discounted using an eighteen percent interest rate	$134,000
Value of gift[53]	$436,000

The taxpayer would then owe, after exclusions and credits, a staggering $84,000 gift tax liability instead of no gift tax liability.[54] The United States Tax Court held in favor of the IRS.[55]

C. *Consequences of Failing to File a Gift Tax Return*

There is no statute of limitations for assessing gift tax when no gift tax return is filed.[56] In the *Ballard* case, the taxpayer filed a gift tax return. Thus, it was upon audit of the gift tax return that the IRS

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[47]*Id* at 323.

[48]*Id.*

[49]I.R.C. § 2512(b) (1976); Treas. Reg. § 25.2512-8 (1958).

[50]Total exclusions were $9000 because there were three donees. *See* I.R.C. § 2503(b) (1976) (in 1981, there was a $3000 exclusion per donee per year from the taxable gift). Hence, the taxable gift was reduced by $9000 from $184,000 to $175,000. The gift tax liability on $175,000 in 1981 was approximately $47,000. *Id.* § 2001(c). The gift tax liability was then reduced by the unified credit against gift tax, which in 1981 was $47,000. *Id.* § 2505(b). Therefore, the taxpayer calculated that she owed no gift tax.

[51]*Ballard*, 53 T.C.M. (CCH) at 324.

[52]*Id.*

[53]I.R.C. § 2512(b) (1976); Treas. Reg. § 25.2512-8 (1958).

[54]*Ballard*, 53 T.C.M. (CCH) at 324; *see also* I.R.C. §§ 2001(c), 2502(a), 2503(b), 2505 (1976).

[55]*Ballard*, 53 T.C.M. (CCH) at 327.

[56]I.R.C. § 6501(c)(3) (1982).

determined a gift tax deficiency. Other taxpayers may have structured transactions similar to the one in *Ballard* except that these other taxpayers, who relied on section 483 rates for gift tax purposes, structured their transactions so that they computed no gift tax liability. Consequently, they would have filed no gift tax returns. If the IRS determines anytime in the future that in fact a gift was made at the time of the transactions because market interest rates that exceeded section 483 interest rates should have been used, the IRS will thus be able to assess the tax at that future time because no statute of limitations applies to unfiled tax returns.[57] It would be quite a shock for taxpayers to expect no gift tax liability and then be informed years later that they owe a substantial amount of gift taxes, interest, and penalties.

IV. Contrast Between Section 483 and Loan Transactions

Section 483 applies to *sales or exchanges* of property under a deferred-payment contract[58] and to payments due under debt instruments given in consideration for the *sale or exchange* of property.[59] In other words, section 483 does not apply to pure loans where there is no sale or exchange of property.

A term loan is a loan that will remain outstanding for a *fixed* term.[60] That is, the borrower receives the right to use the money for a certain period of time.[61] A term loan is treated as a below-market loan if the amount of the loan exceeds the present value of all payments due under the loan.[62] This is similar to the way unstated interest is computed under section 483.[63] Payments made under section 483 are actually in the nature of payments under a term loan because the payments occur for a fixed term.[64] In contrast to a term loan, a demand loan remains outstanding not for a fixed term but only until the lender demands repayment.[65]

Although the *Ballard* case is the first to address the gift tax ramifications of below-market interest deferred sales transactions that fall under section 483, there are cases that have addressed the gift tax

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[57] *Id.*

[58] I.R.C. § 483(c)(1) (Supp. III 1985). *See supra* text accompanying notes 17-18.

[59] I.R.C. § 483(c)(2) (Supp. III 1985). *See supra* text accompanying notes 17-18.

[60] Breitbard, Mattachione & Hasting, *Interest-Free Loans: The Battle Continues*, 42 Inst. on Fed. Tax'n §§ 53.01, 53.02[3] (1984).

[61] Joyce & Del Cotto, *supra* note 37, at 459.

[62] I.R.C. § 7872(e)(1)(B) (Supp. III 1985); Hartigan, *New Law Introduces Major Income and Gift Tax Consequences for Interest-Free Loans*, 13 Tax'n for Law. 116, 118 (1984).

[63] *See* I.R.C. § 483(b) (Supp. III 1985). *See supra* text accompanying notes 14-16.

[64] *See* I.R.C. § 483(a) (Supp. III 1985). *See supra* text accompanying note 13.

[65] Breitbard, Mattachione & Hasting, *supra* note 60, at § 53.02[3].

ramifications of below-market interest demand and term loans.[66] Because section 483 does not concern below-market loans, the cases relating to below-market demand and term loans did not resolve the issue presented in *Ballard*.

V. IRS Position

In 1975, the IRS first addressed the gift and estate tax ramifications of section 483 in internally created General Counsel Memorandum (GCM) 36,355.[67] In its memorandum, the IRS initially stated, "By its terms, this section [483] applies to the entire Code, Title 26 of the United States Code."[68] The IRS continued, "The statute is unambiguous on its face, however, and its provisions clearly extend to all parts of the Code, including the estate and gift tax provisions."[69] The IRS position against the use of section 483 rates for estate and gift tax purposes is based on the fact that section 483 is a remedial measure designed only to prevent the seller of property from converting what would otherwise be ordinary interest income into capital gain income.[70] The IRS also stated:

> The remedy imposed by Code § 483 is to treat part of the amount stated to be principal as interest for purposes of the Federal Income tax. . . . Thus, while Code § 483 is by its terms applicable to the entirety of Title 26, it is actually directed at Subtitle A [the income tax subtitle] of Title 26.[71]

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[66]At first, courts held that below-market demand loans created no gift tax consequences. *See* Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966); Crown v. Commissioner, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978). The IRS, however, maintained that such demand loans did carry gift tax consequences. Rev. Rul. 73-61, 1973-1 C.B. 408, 409. The United States Supreme Court resolved the issue in Dickman v. Commissioner, 465 U.S. 330 (1984), *aff'g* 690 F.2d 812 (11th Cir. 1982), holding that below-market demand loans do create gifts of the reasonable value of the use of the money lent. *Id.* at 344. The dissenting opinion in *Dickman*, however, indicated that the complexity of the gift tax computation imposes a heavy burden on taxpayers who conscientiously try to adhere to the Code. *Id.* at 347 (Powell, J., dissenting).

Below-market term loans were not quite as controversial as below-market demand loans. The IRS view is that below-market term loans involve gift tax ramifications. Rev. Rul. 73-61, 1973-1 C.B. 408, 409. The court in Estate of Berkman v. Commissioner, 38 T.C.M. (CCH) 183 (1979), agreed with this position, holding that below-market term loans not made at arm's length involve gifts of the difference between the fair market value of the property and the fair market value of the consideration received by the donor. *Id.* at 186.

[67]Gen. Couns. Mem. 36,355 (Aug. 4, 1975). GCM's are not to be relied upon or otherwise cited as precedent by taxpayers. *Id.*

[68]*Id.*

[69]*Id.*

[70]*Id.* Capital gain income is still distinct from ordinary income even after the Tax Reform Act of 1986 became effective because capital losses are deductible only to the extent of capital gain income plus $3000 of ordinary income. *See* I.R.C. § 1211(b) (1982).

[71]Gen. Couns. Mem. 36,355 (Aug. 4, 1975).

In short, the IRS asserted that section 483 should apply only for income and not gift tax purposes. However, the IRS contradicted itself by asserting that section 483 applies to the entire Code while simultaneously arguing that it applies only to the income tax subtitle.

The IRS also cited *Blackburn v. Commissioner*[72] in GCM 36,355. In this case, the taxpayer sold property having a fair market value of $245,000 to related parties in exchange for a note with a face amount of approximately $173,000. The taxpayer contended that the amount of the gift was the difference between the fair market value of the property and the face amount of the note. The note bore interest at a rate of two and one-quarter percent payable in monthly installments of $600 over a period of thirty-four years and six months. Similarly to the way unstated interest is computed under section 483, the IRS discounted the note at a four percent interest rate (the usual rate of interest charged on such transactions at that time) to determine the value of the consideration, which turned out to be approximately $135,000. The IRS therefore computed the gift to be the difference between $245,000 and $135,000 instead of $245,000 and $173,000, as the taxpayer contended. In other words, the difference in the present value of the note using a two and one-quarter percent interest rate and a four percent interest rate amounted to a $38,000 [$173,000 - $135,000] increase in the taxable gift. The United States Tax Court held for the IRS.[73] Thus, the IRS asserted in this GCM that market interest rates are to be used in determining the gift tax consequences of deferred sales transactions as they were in *Blackburn*.[74] The *Blackburn* case was decided in 1953; section 483 was not promulgated until 1964.[75] In 1953, there was no section 483 rate that could have been imputed. Therefore, *Blackburn* should not be determinative of the issue presented in *Ballard*.

However the court in *Ballard* relied heavily on *Blackburn*, asserting that the basic valuation principle followed in *Blackburn* was not affected by section 483.[76] The court noted that if valuation of a note for gift tax purposes could be accomplished using section 483 instead of market interest rates, then Congress specifically would have mentioned such a use in the legislative history to section 483.[77] However, Congress may not have anticipated such a problem. What Congress did anticipate was that the rate under section 483 would "reflect the going rate of interest."[78]

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[72]20 T.C. 204 (1953).

[73]*Id.* at 207.

[74]Gen. Couns. Mem. 36,355 (Aug. 4, 1975).

[75]*See* Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19, 77-78.

[76]53 T.C.M. (CCH) 323, 326-27 (1987).

[77]*Id.* at 327.

[78]H.R. Rep. No. 749, *supra* note 4, at 1381; S. Rep. No. 830, *supra* note 4, at 1775. *See infra* text accompanying notes 147-48.

The controversy in *Ballard* arose only because of the eventual discrepancy between section 483 and market interest rates. Furthermore, while Congress may not have mentioned specifically the use of section 483 for gift tax valuation purposes in the 1964 legislative history of the section, Congress did suggest the use of section 483 for valuation purposes in the 1981 legislative history of the section.[79]

The IRS specifically addressed the issue of the section 483 rate of interest also being a "safe-harbor" rate of interest for purposes of the gift tax subtitle in another internally created document—Private Letter Ruling (PLR) 77-46-002.[80] The IRS adopted a similar stance in this PLR to that it had previously taken in the GCM.[81] In this PLR, the IRS stated that the "fair market value of property is not affected by its designation for income tax purposes."[82] In other words, the designation of a portion of the payments as interest or principal under section 483 is not relevant to the determination of whether a gift was made for purposes of the gift tax subtitle. The IRS position is that the fair market value of the consideration received by the seller should always be determined using market interest rates for gift tax purposes.[83] Section 483 merely mandates what portion of the payments is treated as interest for income tax purposes.[84] It is section 2512[85] and not section 483, the IRS maintained, that determines how large the total payments must be regardless of what portion of the payments section 483 designates as interest.[86]

By 1984 the IRS position toward section 483 had changed as indicated in two more internally created memoranda, which suggests the weakness of its position in the first two memoranda. In Technical Advice Memorandum (TAM) 85-05-005,[87] the issue was whether a note should be valued by reference to its face value instead of its fair market value

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[79]*See infra* text accompanying notes 164-70.

[80]Priv. Ltr. Rul. 77-46-002 (July 29, 1977). As with GCM's, PLR's are not to be used or cited as precedent. *Id.*; *see also* I.R.C. § 6110(j)(3) (1982).

[81]*See supra* text accompanying notes 68-71.

[82]Priv. Ltr. Rul. 77-46-002 (July 29, 1977).

[83]*Id.*

[84]*Id.*

[85]I.R.C. § 2512 (1982), which provides in relevant part:

§ 2512. Valuation of gifts

> (a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.
>
> (b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

[86]Priv. Ltr. Rul. 77-46-002 (July 29, 1977).

[87]Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984). This TAM is not to be relied upon or cited as precedent by taxpayers. I.R.C. § 6110(j)(3) (1982).

using prevailing market interest rates for purposes of section 301, which concerns distributions to a shareholder by a corporation. The taxpayer argued that no discount can be made for the discrepancy in interest rates when the "safe-harbor" rate of section 483 is met.[88] The ruling stated that section 483 applies for all purposes of the Code.[89] The ruling further stated that section 483 appears to proceed from the assumption that the parties are dealing at arm's length.[90] When the parties are unrelated, it can be assumed that market forces determined the sale price and interest rate and that there is thus no other component such as a gift.[91] It can be argued, the ruling continued, that it is necessary to use prevailing market rates to determine whether related party transactions have a gift component.[92] However, the ruling contended that the principal objection to this argument is that there is no evidence that there is a related party exception to section 483.[93] In other words, there is no indication that related parties should face gift taxation, as a result of the application of section 483, where unrelated parties would not. The ruling further contended that section 483(b) was designed to afford taxpayers "a degree of certainty in structuring their transactions. Related taxpayers need certainty as much as unrelated taxpayers, and . . . there is no evidence that Congress intended to impose a greater burden on them."[94] The ruling concluded with the language that "the 'safe-harbor' rate of section 483 governs in sales of property for all purposes of the code."[95] Therefore, notes bearing interest at the section 483 prescribed "test rate"[96] should have a fair market value equal to their face value.[97]

In GCM 39,331,[98] the issue was whether the section 483 rate rather than the prevailing market rate was the appropriate rate to use in valuing a note given in exchange for property in a related party transaction. The memo quoted the same arguments used in TAM 85-05-005.[99] The GCM then discussed *Caruth v. United States*,[100] in which the issue was

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[88]Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984).

[89]*Id.*

[90]*Id.*

[91]*Id. See supra* text accompanying notes 33-35 and *infra* text accompanying notes 172-76.

[92]Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984).

[93]*Id.*

[94]*Id.*

[95]*Id.*

[96]"Test rate" can be used interchangeably with "safe-harbor" rate. *See supra* note 43.

[97]Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984).

[98]Gen. Couns. Mem. 39,331 (Jan. 23, 1985). This GCM is not to be relied upon or cited as precedent by taxpayers. *Id.*

[99]*See supra* text accompanying notes 89-94.

[100]411 F. Supp. 604 (N.D. Tex. 1976), *rev'd on other grounds*, 566 F.2d 901 (5th Cir. 1978).

whether the present value of non-interest bearing notes calculated in accordance with section 483 rates was to be treated as the fair market value for purposes of determining the "amount realized" under section 1001.[101] The court looked to the interplay between the Code and the income tax regulations prescribed by the Secretary of the Treasury in order to reach its decision.[102] The court held the present value of the non-interest bearing notes for section 483 purposes to be the fair market value of the notes for purposes of determining the amount realized under section 1001(b).[103] Although the Fifth Circuit did not reach this issue, it did express its difficulty with the trial court's holding. The Fifth Circuit noted that there was no indication that Congress intended to amend section 1001 by adopting section 483.[104] Likewise, the court in *Ballard* expressed difficulty with a similar argument in the *Ballard* case.[105] The court in *Ballard* stated that the "legislative history under section 483 gives no indication that Congress intended to amend the general principles of section 2512 by its adoption of section 483."[106]

While the 1964 legislative history of section 483 does not specifically state that section 483 is an exception to section 2512,[107] section 483 appears to be such an exception.[108] It certainly is not clear. Furthermore, doubtful situations are to be construed in the taxpayer's favor.[109] Also, the 1981 legislative history of section 483 does suggest that section 483 may be an exception to section 2512.[110] As the trial court in *Caruth* reasoned, the present value of the notes for section 483 purposes should be the fair market value of the notes for gift tax purposes. That is, the present value of the notes should be determined using section 483 rates even for gift tax purposes if section 483 applies to the transaction.

VI. Taxpayer Position

A. *Statutory Construction*

The wording of a statute is very important in determining its meaning because the starting point for construction of a statute is the language

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[101]*Id.* Section 1001 describes the determination of the amount of and recognition of gain or loss on sales transactions. *See* I.R.C. § 1001 (1982 & Supp. III 1985).

[102]*Caruth*, 411 F. Supp. at 607.

[103]*Id.* at 608.

[104]*Caruth*, 566 F.2d at 905.

[105]*See supra* text accompanying notes 42-55.

[106]53 T.C.M. (CCH) 323, 326 (1987).

[107]*See supra* note 30 and accompanying text.

[108]*See supra* text accompanying notes 78-79 and *infra* text accompanying notes 152-53.

[109]*See infra* text accompanying note 127.

[110]*See infra* text accompanying notes 164-70.

of the statute itself.[111] As a result, the wording of section 483 should be examined carefully. Where a statute is clear on its face, unequivocal evidence of legislative purpose is required to override the plain meaning of the words used in the statute.[112] Furthermore, words are to be given their ordinary meaning unless intent to the contrary is shown.[113]

Congress has amended section 483 three times in the last five years,[114] but each time it has retained the same introduction—"For purposes of this title . . . ."[115] Section 483(a) states that "[f]or purposes of this *title*," payments to which this section applies shall be divided into interest and principal.[116] The word "title" refers to Title 26 of the United States Code (U.S.C.) in which the Internal Revenue Code of 1954 (Code) is codified.[117] The Code is broken down into subtitles, chapters, subchapters, parts, sections, and subsections. The word title therefore includes the gift tax portion of the Code, Subtitle B, Chapter 12.[118] Furthermore, the regulations prescribed by the Secretary of the Treasury (Treasury Regulations) provide that interest imputed under section 483 constitutes interest for all purposes of the Code.[119] Despite the fact that section 483 is in the income tax subtitle, Subtitle A, the plain language of section 483 states that it applies for purposes of this "title"[120]—not for purposes of this "subtitle."[121] There are several code sections in the income tax subtitle that begin with the words "[f]or purposes of this subtitle . . . ."[122] Presumably, the application of these sections would

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[111]*See, e.g.*, Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980); United States v. W.M. Webb, Inc., 402 F.2d 956, 959 (5th Cir. 1968), *rev'd on other grounds*, 397 U.S. 179 (1969); United States v. Northumberland Ins. Co., 521 F. Supp. 70, 76 (D.N.J. 1981).

[112]*See, e.g.*, Ken-Rad Tube & Lamp Corp. v. Commissioner, 180 F.2d 940, 942 (6th Cir. 1950); Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33, 36 (6th Cir. 1945); Huntsberry v. Commissioner, 83 T.C. 742, 747-48 (1984).

[113]*See, e.g.*, Perrin v. United States, 444 U.S. 37, 42 (1979); Hanover Bank v. Commissioner, 369 U.S. 672, 687 (1961); Crane v. Commissioner, 331 U.S. 1, 6 (1946); United States v. Brown Wood Preserving Co., 275 F.2d 525, 528 (6th Cir. 1960); William Powell Co. v. United States, 524 F. Supp. 841, 845 (S.D. Ohio 1981); Greer v. United States, 269 F. Supp. 801, 803 (E.D. Tenn. 1967), *aff'd*, 408 F.2d 631 (6th Cir. 1969).

[114]*See infra* notes 154, 184, 207 and accompanying text.

[115]*Compare* I.R.C. § 483(a) (Supp. III 1985) *with* I.R.C. § 483(a) (Supp. II 1984) *and* I.R.C. § 483(a) (1982) *and* I.R.C. § 483(a) (1976).

[116]I.R.C. § 483(a) (Supp. III 1985) (emphasis added). *See supra* text accompanying note 13.

[117]26 U.S.C. §§ 1-9602 (1982 & Supp. III 1985).

[118]*Id.* §§ 2501-2524.

[119]Treas. Reg. § 1.483-2(a)(1)(i) (1966); *see also* Carlson, *supra* note 16, at 192-93.

[120]I.R.C. § 483(a) (Supp. III 1985).

[121]*See supra* note 13 and *infra* text accompanying note 122.

[122]*See, e.g.*, I.R.C. §§ 62-65, 152, 1221-1223 (1982 & Supp. III 1985).

be limited to Subtitle A. Section 7872,[123] for example, which is in Subtitle F, also begins with the words "[f]or purposes of this title"[124] and is not limited to the particular section, chapter or even subtitle in which it is found. For instance, section 7872(d)(2) makes a reference to the application of section 7872 for purposes of Chapter 12, which is in Subtitle B.[125] Merely because section 483 is in the income tax subtitle does not mean that it cannot apply to the gift tax subtitle. The Code itself provides that no inference, implication, or presumption of legislative construction shall be made or drawn by reason of the location of any particular section.[126]

In ambiguous situations, courts have held that the taxpayer is entitled to the benefit of the doubt.[127] Therefore, taxpayers who rely on the language in section 483, which states that it applies for purposes of this title, and structure their tax transactions to avoid incurring a gift tax should be given the benefit of the doubt if these words in the statute are found to be ambiguous.

The following two cases demonstrate that courts have applied section 483 to other Code sections. In *Robinson v. Commissioner*,[128] the issue was whether section 483 applied to section 453(b),[129] a provision concerning installment sales. The court reasoned that section 483 applies to section 453(b) because the provisions of section 483 are to apply "for purpose[s] of this title."[130] The court stated that "inherent in the issue presented is the question of the scope of section 483, and specifically the question of whether it applies in the determination of the selling price under section 453(b)(2)."[131] This language indicates that the court looked at the scope in a *general* sense as well as a specific sense. So, there is no reason for inferring that the court meant anything except that section 483 should apply for *all* purposes of Title 26—including gift tax purposes. In affirming this decision, the Eighth Circuit stated, "Even though § 483 does not specifically refer to § 453, the former provision is applicable to § 453 because § 483 is couched in the comprehensive and unambiguous language that it is to apply for 'purposes

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[123]*See infra* text accompanying notes 196-206.

[124]I.R.C. § 7872(a)(1) (Supp. III 1985).

[125]*See id.* § 7872(d)(2).

[126]I.R.C. § 7806(b) (1982).

[127]*See, e.g.*, Old Colony R. v. Commissioner, 284 U.S. 552, 561 (1932); Ransburg Corp. v. Commissioner, 621 F.2d 264, 268 (7th Cir. 1980); Busse v. Commissioner, 479 F.2d 1147, 1151 (7th Cir. 1973); Charles Leich & Co. v. United States, 210 F.2d 901, 907 (7th Cir. 1954).

[128]54 T.C. 772 (1970), *aff'd*, 439 F.2d 767 (8th Cir. 1971).

[129]54 T.C. at 778.

[130]*Id.*

[131]*Id.*

of this title' (the Internal Revenue Code, Title 26)."[132] Nowhere in this opinion is there any indication that section 483 should be limited to income tax purposes of the Code even though section 453, as well as section 483, is in the income tax subtitle.

Citing *Robinson*, the court in *Rose v. Commissioner*,[133] stated that Congress, in passing the Revenue Act of 1964,[134] intended section 483 to "be applied retroactively not only to the types of transactions expressly contemplated therein, but 'for all purposes of the Code.' "[135] If section 483 is to be applied retroactively for all purposes of the Code, then it should also be applied prospectively for all purposes of the Code. That is, there is no reason why the application of section 483 to other parts of the Code should be limited to a retroactive application.

The court in *Ballard* agreed with the taxpayer that section 483 is not restricted to Subtitle A of the Code.[136] However, the court disagreed with the taxpayer's argument that section 483 applied for valuation purposes, asserting that section 483 had nothing to do with valuation purposes.[137] The court noted that the purpose of section 483 is to recharacterize portions of payments on deferred sales transactions as interest payments.[138] However, when a portion of a payment is recharacterized as interest, that necessarily leaves a smaller portion to be characterized as principal. Therefore, in essence, section 483 acts to devalue the payments being made on an installment contract. If the language in section 483 is being misinterpreted by taxpayers, Congress could clarify the section by simply changing the word "title" to "subtitle" in section 483(a). Construction should not be substituted for legislation.[139]

B. Discrepancy Between Section 483 and Market Interest Rates in the 1980's

The origin of the controversy regarding section 483 is the discrepancy between the section 483 interest rate and market interest rate. This problem began prior to the enactment of amendments to section 483 in the 1980's. Even during periods where the section 483 and market interest rate are approximately the same, and hence the issue of which

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[132] *Robinson*, 439 F.2d at 768.

[133] 55 T.C. 28 (1970).

[134] Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19.

[135] *Rose*, 55 T.C. at 31. The court discussed retroactive application of section 483 because that was the specific issue in the case. *See id.* at 28.

[136] 53 T.C.M. (CCH) 323, 326 (1987).

[137] *Id.*

[138] *Id.*

[139] *See, e.g.*, United States v. Missouri Pac. R.R., 278 U.S. 269, 278 (1929); Busse v. Commissioner, 479 F.2d 1147, 1151 (7th Cir. 1973).

rate to use in currently structuring a deferred sales transaction becomes insignificant, the IRS still may be able to challenge currently the issue of which rate should have been used in a previously structured deferred sales transaction.[140]

1. Pre-1982.—Section 483, as it existed before 1982,[141] stated that the present value of payments should be determined as of the date of the sale or exchange by discounting the payments at the rate provided in the regulations prescribed by the Secretary of the Treasury.[142] Section 483 originally provided for "test" or "safe-harbor" rates by which the IRS would measure whether interest needed to be imputed.[143] In other words, if the taxpayer charged at least the test rate, no interest would be imputed.[144] By 1981, the test rate under section 483 was six percent,[145]

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[140]*See supra* text accompanying notes 56-57.

[141]I.R.C. § 483(a)-(b) (1976), which provides:

§ 483. Interest on certain deferred payments

(a) Amounts constituting interest

For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) Total unstated interest

For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

[142]*Id.* § 483(b).

[143]H.R. Rep. No. 749, *supra* note 4, at 1382; S. Rep. No. 830, *supra* note 4, at 1776; Treas. Reg. § 1.483-1(d) (as amended in 1981). *See supra* note 43.

[144]Before July 24, 1975, the test rate was 4% per annum simple interest, and the imputed rate was 5% per annum compounded semiannually. Treas. Reg. § 1.483-1(d)(1)(ii)(A) (T.D. 6873, 1966-1 C.B. 101); Treas. Reg. § 1.483-1(c)(2)(ii)(A) (T.D. 6873, 1966-1 C.B. 101). From July 23, 1975 to July 1, 1981, the test rate was 6% simple interest, and the imputed rate was 7% compounded semiannually. Treas. Reg. § 1.483-1(d)(1)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135); Treas. Reg. § 1.483-1(c)(2)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135). After July 1, 1981, the test rate under section 483 was 9% simple interest, and the imputed rate was 10% compounded semiannually. Treas. Reg. § 1.483-1(d)(1)(ii)(C) (as amended by T.D. 7781, 1981-2 C.B. 123); Treas. Reg. § 1.483-1(c)(2)(ii)(C) (as amended by T.D. 7781, 1981-2 C.B. 122).

[145]Treas. Reg. § 1.483-1(d)(1)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135).

and the market interest rate was into the double digits;[146] there was a wide margin between the section 483 and market rate.

In enacting section 483, Congress stated that "[i]t is anticipated that any rate specified by the Secretary of the Treasury or his delegate will reflect the going rate of interest and will not be higher than the rate at which a person . . . could be expected to borrow money from a bank."[147] Congress then stated that a rate of five percent was appropriate at that time—1964.[148] Congress seemed more concerned about the section 483 interest rate specified by the Secretary being too high than it did about the rate being too low. There would be no gift tax quandary if the Secretary had kept interest rates under section 483 at the "going" rate of interest. In other words, there would be no controversy if the section 483 rate and the market rate of interest were the same. Five percent may have been an appropriate rate in 1964, but the test and imputed rates of six and seven percent certainly did not "reflect the going rate of interest" in 1981. In discussing the Economic Recovery Tax Act (ERTA)[149] amendments to section 483, Senator Melcher, sponsor of one of the amendments, stated:

> [T]his amendment deals with imputed interest rates, which is a term that the IRS uses when they wish to make certain, under section 483 of the Codes, that there will be a proper interest rate on the sale of realty. By "proper" I mean an interest rate that they think is realistic.[150]

Because Congress gave the Secretary the power to change the interest rate under section 483 to keep it "realistic,"[151] one can presume that the IRS believed that the section 483 rate was "realistic" or else it would have changed it. By not updating the interest rate under section 483 to reflect the market rate of interest, it appeared as though section 483 were a special exception to the requirement of charging the market rate of interest in order to avoid making a taxable gift. That is, it is easy to see why taxpayers could have thought that if a transaction fell under section 483, then all they needed to charge was the section 483 rate, a rate the IRS had the power to change[152] and a rate Congress had anticipated would be "realistic."[153] Because of the variance between

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[146]*See, e.g.*, N.Y. Times, June 2, 1981, at D11, col. 6.

[147]H.R. Rep. No. 749, *supra* note 4, at 1381; S. Rep. No. 830, *supra* note 4, at 1775.

[148]H.R. Rep. No. 749, *supra* note 4, at 1381; S. Rep. No. 830, *supra* note 4, at 1775.

[149]*See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 126, 95 Stat. 172, 202.

[150]127 Cong. Rec. 17,805 (1981).

[151]I.R.C. § 483(b) (1976).

[152]*Id.*

[153]127 Cong. Rec. 17,805 (1981).

the section 483 rate of interest and the market rate of interest, a "tax trap" was created for sellers in property transactions that fell under section 483. That is, taxpayers whose transactions fell under section 483 could logically rely on the section 483 rate of interest as a "safe-harbor" rate for "all purposes of the Code" and yet later be told that they should have used the market rate of interest instead.

2. *After ERTA.*—Section 483 was amended by the Economic Recovery Tax Act (ERTA) of 1981.[154] In 1981, Congress, under ERTA, added subsection (g) [now (e)] to section 483.[155] Section 483(g) [now (e)] limited the maximum interest rate used in determining total unstated interest to seven percent compounded semiannually in the case of a "qualified sale."[156] Qualified sale means a sale or exchange of land to a family member.[157] The section 483(g) [now (e)] rate does not apply to qualified sales that exceed $500,000.[158] If the $500,000 limit is exceeded during the calendar year, the lower rate is available only as to the first sales or exchanges up to that limit.[159] The Senate amendment provided

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[154]Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 126, 95 Stat. 172, 202; *see also* S. Rep. No. 144, 97th Cong., 1st Sess. 1, *reprinted in* 1981 U.S. Code Cong. & Admin. News 105.

[155]I.R.C. § 483(g) (1982), which provides in relevant part:

> (g) Maximum rate of interest on certain transfers of land between related parties
>
> (1) In General
>
> In the case of any qualified sale, the maximum interest rate used in determining the total unstated interest rate under the regulations under subsection (b) shall not exceed 7 percent, compounded semiannually.
>
> (2) Qualified Sale
>
> For purposes of this subsection, the term 'qualified sale' means any sale or exchange of land by an individual to a member of such individual's family (within the meaning of section 267(c)(4)).
>
> (3) $500,000 Limitation
>
> Paragraph (1) shall not apply to any qualified sale between individuals made during any calendar year to the extent that the sales price for such sale (when added to the aggregate sales price for prior qualified sales between such individuals during the calendar year) exceeds $500,000.

[156]*Id.* § 483(g)(1).

[157]*Id.* § 483(g)(2).

[158]*Id.* § 483(g)(3).

[159]H.R. Conf. Rep. No. 215, 97th Cong., 1st Sess. 281, *reprinted in* 1981 U.S. Code Cong. & Admin. News 285, 370 [hereinafter H.R. Conf. Rep. No. 215]; 51 Fed. Reg. 12,024 (1986). For example, if property is sold during the calendar year for $400,000, the 7% interest rate would be applicable. If more property is later sold during the same calendar year for $150,000, the 7% interest rate would not be applicable to the $150,000 sale because the $500,000 limitation would have been exceeded. *See* Prop. Treas. Reg. § 1.483-4(b)(2)(iv), 51 Fed. Reg. 12,044 (1986). However, the parties can structure a sale with two debt instruments. One can have a $100,000 face amount and the other a $50,000 face amount. The 7% rate would apply to the $400,000 and $100,000 instruments but not to the $50,000 face amount. The $500,000 limitation would not have been exceeded

that the seven percent rate be applied to sales of non-depreciable property for less than $2 million.[160] The special seven percent rate was established in reaction to the 1981 increase in the section 483 test and imputed interest rates.[161] The Conference Agreement adopted section 483(g) [now (e)] from the Senate Amendment.[162] By providing a lower rate of interest for related parties under section 483(g) [now (e)] than for unrelated parties whose transactions fall under section 483, Congress intentionally widened the gap between the section 483 and market rate of interest where related parties are concerned. This does one of two things: either it further evidences that a tax trap has been created under section 483 that needs to be remedied, or it clarifies that section 483 rates really are to be applied for *all* purposes of the Code. If Congress anticipated the section 483 rate to be "realistic,"[163] then by adjusting it under section 483(g) [now (e)], Congress may have set what it considered to be a "realistic" rate for related parties whose transactions fall under section 483, or Congress may have wanted to provide a "tax break" to related parties. In either case, no higher interest rate should be applied to a related party transaction falling under section 483 for any purpose under the Code because Congress has already provided either a "realistic" rate or a rate with a "tax break" in mind for related parties.

a. Legislative History.—Senators' comments during discussion of the amendment are indicative of how they viewed section 483 transactions. The Senate amendment was primarily concerned with an excessive, imputed interest rate on sales of farms and small businesses.[164] Senator Melcher remarked that "it is vitally important that we hold these rates down, particularly in the sale of family farms, family ranches, and small businesses . . . ."[165] Senator Boschwitz commented that "[t]his amendment is a reasonable compromise to relieve the burdens the regulations impose on family farms and small businesses."[166] Senator Grassley said:

> One of the tools for assessability of younger generations to continue the family farming operation has been the lower rate of interest that mothers or fathers have been willing to give to their sons and daughters in helping to start this family farm operation or small business.

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by the total of the first $400,000 instrument and the second $100,000 instrument. *See* 51 Fed. Reg. 12,024 (1986).

[160] H.R. Conf. Rep. No. 215, *supra* note 159, at 370.

[161] *Id. See supra* note 144.

[162] H.R. Conf. Rep. No. 215, *supra* note 159, at 370.

[163] *See* 127 Cong. Rec. 17,805 (1981).

[164] *Id.*

[165] *Id.*

[166] *Id.* at 17,806.

> This intergenerational loan or gift is not ever in the vein of trying to pull something fast on the Government. This is a very open approach of one generation willing to forgo some income just because of the desire to see the family farm continue within the family from one generation to the other.[167]

These comments indicate an intent to enable farmers, small businessmen, and their families to structure their deferred sales transactions with lower interest rates. Senator Grassley even recognized the possibility of a gift, but his comments do not suggest that the transaction should be subject to gift taxation. The purpose of the lower interest rate is to enable farmers and small businessmen to keep the property in the family without their children incurring high interest rates—"one generation willing to forgo some income."[168] It is unlikely that Senator Grassley contemplated that the generation "willing to forgo some income" must also be willing to incur a financially devastating gift tax on the difference between the safe-harbor interest rate under section 483 and the current market rate of interest.

Senator Jepsen commented:

> When the time comes for a child to get started in business or farming, he or she cannot afford 20-percent interest rates and the enormous initial capital expenditures. So, a father and mother give the child a break: A low-interest loan and a deferred payment schedule. This does two things: It helps the young person when such help is critical and allows parents to pass on their property to their offspring without incurring the confiscatory rates of present estate taxation.[169]

Senator Jepsen's comments do not suggest that parents would escape being subject to estate taxation only at the expense of being subject to gift taxation. Otherwise, that would defeat Senator Jepsen's philosophy of making it easier for parents to transfer the property to their offspring.

The Senator's comments do not in any way suggest that section 483 transactions, where the section 483 rate of interest has been used, should be subject to gift taxation. Furthermore, the General Explanation of the Economic Recovery Tax Act of 1981 regarding section 483(g) [now (e)] indicates that an undue burden would be placed on sales of land between related parties if the lower rate of interest under section 483(g) [now (e)] were not enacted.[170]

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[167] *Id.*

[168] *Id.*

[169] *Id.*

[170] Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981 60 (1981).

b. Related Party Transactions.—As discussed previously, a gift tax will not be imposed on all transactions in which the value of the consideration is less than the fair market value of the property.[171] Where the transaction is a genuine business transaction, in contrast to a family type transaction, generally no gift will be found.[172] Intra-family transfers have always prompted special scrutiny by courts, in regard to determining if a gift has been made, precisely because a genuine business transaction cannot usually be found.[173] A close look at the transaction is unavoidable.[174] However, gift tax will not be imposed on arm's length transactions that have a bona fide business objective and involve no element of donative intent.[175] Furthermore, it is not an essential requirement in such transactions that the property be transferred for a full and adequate consideration in money or money's worth in order to preserve the legitimate business character of the property transfer.[176] Bad bargains and sales for less than a full and adequate consideration are commonplace in the business world; the tax law does not insist that such transactions necessarily involve gift transfers.[177] Moreover, a family transaction may be treated as one "in the ordinary course of business" if each of the parenthetical criteria in Treasury Regulation section 25.2512-8[178] is fully met.[179] A taxpayer's reliance on the section 483 rate of interest could show that there was no intent to make a gift and thus render the transaction free of any donative intent, bona fide, and one made at arm's length. In other words, by relying on section 483 rates, the taxpayer is not merely charging a "low" rate of interest, but instead is intentionally complying with section 483 of the Internal Revenue Code. Gifts have not always been found in transactions between related parties where there is no donative intent even where less than a full and adequate consideration is received.[180]

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[171] *See supra* text accompanying notes 29-35.

[172] *See, e.g.*, Estate of Anderson v. Commissioner, 8 T.C. 706, 720 (1947).

[173] *See, e.g.*, Fehrs v. United States, 620 F.2d 255, 260 (Ct. Cl. 1980) (taxpayer's transfer of shares of stock to a newly created corporation wholly owned by taxpayer's daughters was in part a gift by taxpayer to corporation to the extent of the excess of fair market value of the transferred shares of stock over consideration received); Estate of Reynolds v. Commissioner, 55 T.C. 172, 201 (1970).

[174] *See, e.g.*, *Fehrs*, 620 F.2d at 260.

[175] *Id.*

[176] *Id.*

[177] *Id.*; *Estate of Anderson*, 8 T.C. at 720.

[178] *See supra* text accompanying note 31.

[179] Estate of Berkman v. Commissioner, 38 T.C.M. (CCH) 183, 185-86 (1979).

[180] *See* Messing v. Commissioner, 48 T.C. 502, 511-12 (1967) (no gift was found where a father sold stock to his son at a price below its worth because there was held to be no donative intent).

Essentially, unrelated parties whose transactions fall under section 483 and who use section 483 rates when market rates are higher would be unlikely to face gift tax problems. This will be true even if market rates and not section 483 rates apply for gift tax purposes because unrelated party transactions will generally not be subject to gift taxation.[181] It is only related party transactions that are normally subject to gift taxation.[182] It is inconsistent to allow unrelated parties to succeed in charging the section 483 rate without incurring any gift tax, while forcing related parties to meet the market rate of interest in order to avoid gift taxation when both parties' transactions fall under section 483. This is especially so because section 483(g) [now (e)] was created, which provides a special *lower* rate of interest for related party transactions.[183] It misleads taxpayers, defeats reliance expectations, and is inconsistent with legislative intent for the IRS to maintain that related taxpayers must charge the section 483 interest rate for income tax purposes but must charge the higher market interest rate to avoid gift taxation. Nowhere in section 483(g) [now (e)] or anywhere else in section 483 is it mentioned that imputation of interest is limited to income tax purposes.

3. *1984 Amendments.*—Section 483 was again amended by the Deficit Reduction Act of 1984.[184] Congress recognized that the safe-harbor and imputed interest rates under section 483 did not represent economic rates of interest for three reasons.[185] First, section 483 rates had not kept up with market rates.[186] Second, test rates under section 483 did not use compounding features.[187] Third, use of a single rate for all obligations failed to recognize that lenders typically demand different rates of return on investments depending upon the term of the loan.[188] In other words, Congress recognized that the section 483 rates were not as high as market rates of interest; until 1984, Congress chose to do nothing about the disparity. There is no reason why the seller should suffer merely because the section 483 rates were not adjusted to market rates. Again, it appears that section 483 is an exception to the rule that a below-market interest rate deferred payment transaction between related parties involves a gift.

The Deficit Reduction Act provides that the new rates under section 483 vary according to the maturity of the obligations and that the rates

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[181]*See supra* text accompanying note 34.

[182]*See supra* text accompanying note 33.

[183]I.R.C. § 483(g)(1) (1982). *See supra* note 155.

[184]Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 41, 98 Stat. 494, 553-55; *see also* H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, 1, *reprinted in* 1984 U.S. Code Cong. & Admin. News 697 [hereinafter H.R. Rep. No. 432].

[185]H.R. Rep. No. 432, *supra* note 184, at 908.

[186]*Id.*

[187]*Id.*

[188]*Id.*

be adjusted at six-month intervals.[189] The new rates are determined under section 1274(d).[190] Section 1274(d) rates are the applicable federal rates (AFR), which consist of a short term rate (term not over three years), a mid-term rate (term over three years but not over nine years), and a long term rate (term over nine years).[191] The applicable federal rate is determined by the Secretary of the Treasury based on the average market yield on outstanding marketable obligations of the United States.[192]

Congress, recognizing that interest rates under section 483 had not kept up with market rates, changed the section 483 rates to approximate more closely the market rates. However, Congress retained the special lower rate for related party transactions under section 483(g), redesignated as section 483(f)[193] [presently section 483(e)]. It is not clear why Congress changed the interest rates under section 483, with regard to gift tax consequences. It could be that Congress changed the section 483 rates for income tax purposes only; that is, that section 483 rates never were meant to be applied for gift tax purposes. In the alternative, it is tenable that for gift tax purposes, Congress wanted to close the discrepancy in rates, providing only section 483(f) [now (e)] as an exception.

Section 483 was severely curtailed by the 1984 Act so that it applies only to transactions excepted from the original issue discount (OID) rules.[194] Section 483 now applies only to a sale or exchange of a farm if the sales price does not exceed $1 million, sales of a principal residence, sales involving total payments of $250,000 or less, and qualified sales of land under section 483.[195]

4. *Section 7872.*—Section 7872 was enacted in 1984.[196] The enactment of section 7872 further shows Congress' intent that when section 483 applies, no other Code section will impute a higher rate of interest to the transaction. Section 7872 is the legislative response to *Dickman v. Commissioner*.[197] This section deals with the treatment of loans with

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[189] *Id.* at 913.

[190] I.R.C. § 483(b) (Supp. III 1985).

[191] *Id.* § 1274(d)(1)(A).

[192] *Id.* § 1274(d)(1)(C).

[193] *See* I.R.C. § 483(f) (Supp. II 1984).

[194] The principal of the original issue discount rules (§§ 1271-1275) is very similar to unstated interest under I.R.C. § 483. Where a transaction falls under the OID rules, the law discounts all payments due by a minimum interest rate so that OID may be computed. OID is taxable as interest income to the holder of the debt instrument. 8 Fed. Taxes (P-H) ¶ 32,923 (1987).

[195] *See* I.R.C. § 1274(c)(3) (Supp. III 1985); H.R. Rep. No. 432, *supra* note 184, at 913; Prop. Treas. Reg. § 1.483-1(c), 51 Fed. Reg. 12,038-39 (1986); *see also id.* at 12,023.

[196] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494, 699. *See also* H.R. Rep. No. 432, *supra* note 184, at 1017.

[197] 465 U.S. 330 (1984), *aff'g* 690 F.2d 812 (11th Cir. 1982). *See supra* note 66.

below-market interest rates.[198] Section 7872 generally treats below-market gift loans as bearing fair market value interest, and treats the lender as making a gift to the borrower.[199] A gift loan is defined in section 7872 as a below-market loan where the forgone interest is in the nature of a gift.[200] The computation of the amount treated as having been transferred from the lender to the borrower under section 7872 is similar to the computation of unstated interest under section 483.[201] As in section 1274(d), the rate used under section 7872 is the applicable federal rate.[202]

Section 7872 does not apply to any loan to which section 483 or 1274 applies.[203] However, section 7872, and not section 483, will apply to below-market loans that are gift loans under section 7872 *and* are debt instruments described in section 1275(b), which concerns transactions involving personal use property.[204] Section 7872 is the Code section that Congress drafted specifically to address the treatment of loans with below-market interest including gift tax ramifications.[205] Congress not only did not provide for an imputed rate of interest for gift tax purposes under section 7872 to apply to section 483 transactions, but, on the contrary, Congress also specifically exempted section 483 transactions from the general scope of section 7872.[206]

5. *Present-Day Section 483.*—Section 483 was further amended by the 1985 Simplification of Interest Rules.[207] Section 483(f), which provided the special rate for certain related party transactions, was redesignated as section 483(e).[208] Simultaneously, Congress lowered the seven percent rate under section 483(e) to six percent to apply to transactions occurring after June 30, 1985.[209] When section 483 was first enacted, Congress

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[198]*See* I.R.C. § 7872 (Supp. III 1985).

[199]Orbach, Fireman & Levenson, *Planning for Tax Advantages Under Proposed Below-Market Loan Regs.*, 64 J. TAX'N 144, 144 (1986).

[200]I.R.C. § 7872(f)(3) (Supp. III 1985).

[201]*See id.* §§ 483(b), 7872(b)(1). A gift loan that is also a term loan is computed in this fashion. *Id.* § 7872(d)(2). *See supra* text accompanying notes 14-16.

[202]I.R.C. § 7872(f)(1) (Supp. III 1985). *See supra* text accompanying notes 189-92.

[203]I.R.C. § 7872(f)(8) (Supp. III 1985); Willbanks, *Interest-Free Loans Are No Longer Free: Tax Consequences of Gift Loans*, 47 MONT. L. REV. 39, 60-61 (1986).

[204]Prop. Treas. Reg. § 1.7872-2(a)(2), 50 Fed. Reg. 33,557 (1985); *see also* Prop. Treas. Reg. § 1.483-1(c)(3)(iii), 51 Fed. Reg. 12,039 (1986); 51 Fed. Reg. 12,023 (1986); Orbach, Fireman & Levenson, *supra* note 199, at 145. Personal use property is defined as property substantially all of the use of which is not in connection with a trade or business of the taxpayer. I.R.C. § 1275(b)(3) (Supp. III 1985).

[205]*See* I.R.C. § 7872 (Supp. III 1985).

[206]*Id.* § 7872(f)(8).

[207]Simplification of Imputed Interest Rules, Pub. L. No. 99-121, § 102, 99 Stat. 505, 508; *see also* S. REP. No. 83, 99th Cong., 1st Sess. 1, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 407 [hereinafter S. REP. No. 83].

[208]*See* I.R.C. § 483(e) (Supp. III 1985).

[209]*Id.*; *see also* Prop. Treas. Reg. § 1.483-4(b)(2), 51 Fed. Reg. 12,044 (1986).

had provided for a test or safe-harbor rate of interest and a one percent higher imputed rate of interest.[210] However, Congress concluded in 1985 that the higher imputation provided often acted as a penalty for uninformed taxpayers.[211] Knowledgeable taxpayers would always avoid the higher imputation rate by providing for stated interest at the applicable test rate.[212] Accordingly, the Committee bill eliminated the higher imputation rate.[213]

a. Proposed Treasury Regulations.—The rates used under section 483 were again modified by the 1986 Proposed Treasury Regulations to be the lower of: (1) the applicable federal rate (based on the appropriate compunding period), or (2) nine percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.[214] This retains the problem of the appropriate rate to charge for gift tax purposes if the market rate exceeds nine percent. In that case, even if market rates and the AFR are approximately the same, the section 483 rate will still be lower than the market rate because the section 483 rate will be nine percent.[215] Also, the section 483(e) rate for related party transactions is only six percent.[216]

The proposed regulations attempt to solve the section 483-market interest rate dilemma but are less than clear. The proposed regulations provide that in a related party transaction where the consideration furnished by the buyer to the seller consists of one or more debt instruments, the value of such debt instrument which has adequately stated interest under Proposed Regulation section 1.483-2 shall be its issue price.[217] A contract generally provides for adequate stated interest under Proposed Regulation section 1.483-2 if it calls for interest at least equal to the test rate of interest.[218] The value of such debt instrument described above issued under a contract to which section 483 applies shall be the amount described in Proposed Regulation section 1.483-3(a)(2)(i).[219] Such amount is the sum of the present values of the deferred payments and the present values of interest payments due under the contract.[220] Thus, it appears that under these proposed regulations, if the parties are related and

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[210] H.R. Rep. No. 749, *supra* note 4, at 1382; S. Rep. No. 830, *supra* note 4, at 1776.

[211] S. Rep. No. 83, *supra* note 207, at 420.

[212] *Id.*

[213] *Id.*

[214] Prop. Treas. Reg. § 1.483-4(a)(1)-(2), 51 Fed. Reg. 12,043 (1986).

[215] *Id.*

[216] I.R.C. § 483(e) (Supp. III 1985).

[217] Prop. Treas. Reg. § 1.1012-2(b)(1), 51 Fed. Reg. 12,047 (1986).

[218] *Id.* § 1.483-2(a), 51 Fed. Reg. 12,039 (1986).

[219] *Id.* § 1.1012-2(b)(2), 51 Fed. Reg. 12,047 (1986).

[220] *Id.* § 1.483-3(a)(2)(i), 51 Fed. Reg. 12,043 (1986).

charge the appropriate section 483 rate, then the value of the consideration will be the issue price. If the issue price is the fair market value, there will be no gift.[221]

b. Movement Toward Reform.—At an annual meeting in Orlando, Florida, the Board of Regents of the American College of Probate Counsel (ACPC) adopted the recommendation of the Estate and Gift Tax Committee that the safe-harbor provisions in section 483 be carried over to Chapter 12 (gift tax) of the Internal Revenue Code.[222] The ACPC noted that the interplay among Proposed Regulation sections 25.2512-8, 1.1012-2(b)(1) and 1.483-4(b)(2) *appears* to cure the section 483(e) bargain sale problems for gift tax purposes.[223] If this is so, non-section 483(e) transactions would also likely be safe for gift tax purposes because the section 483(e) rate is even lower than the rate under non-section 483(e) transactions. However, three different regulations need to be examined even to come to a tentative conclusion, which at best suggests that the area is confusing. Also, the word "appears" is the key word in the ACPC's conclusion, which again suggests that the area is confusing. In *Ballard*, the court suggested that section 7872 probably prevents a case similar to *Ballard* from arising in the furture.[224] Even the court is not sure.

Even if these Proposed Treasury Regulations are adopted and do solve the section 483-market interest rate "tax trap" so that the issue does not occur in currently structured transactions, the resolution of this issue as presented in *Ballard*[225] is still very important. This is because the IRS still may be able to challenge currently the issue of which rate should have been used in a past deferred sales transaction.[226]

VII. Conclusion

Although the legislative history, regulations, recent IRS rulings, and the Code sections themselves indicate that a gift tax problem does not arise when the section 483 rate of interest is used in deferred sales transactions, this area of the law is confusing, especially when early IRS rulings and the court in *Ballard* indicated that section 483 applies for income tax purposes only. What Congress needs to do is to clarify section 483, either spelling out the fact that section 483 applies for all purposes of the Code "including gift and estate tax purposes," or specifying that section 483 applies "for income tax purposes only." In

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[221] *See supra* text accompanying note 30.

[222] Horsley, *Some More Taxing Problems*, 12 Prob. Notes 87, 88 (1986).

[223] *Id.* at 89.

[224] 53 T.C.M. (CCH) 323, 327 (1987).

[225] *See supra* text accompanying notes 42-55.

[226] *See supra* text accompanying notes 56-57.

other words, Congress should provide for a gift tax safe-harbor rate, or specify that there is only an income tax safe-harbor rate. This clarification would bring greater certainty to the area and eliminate the "tax trap" into which taxpayers may otherwise fall. As for taxpayers who may have relied on section 483 to structure their transactions in the past, it would be terribly inequitable to apply retroactively an amendment that section 483 applies for income tax purposes only, because there was never any definite indication in the past that section 483 applied for income tax purposes only. If at all, the indication was that section 483 applied for gift as well as income tax purposes.

Jay D. Benjamin

Wrongful Adoption: Monetary Damages as a Superior Remedy to Annulment for Adoptive Parents Victimized by Adoption Fraud

I. Introduction

Most adoption disputes involve four general classes of persons: the adopted child, the natural parents, prospective heirs of the adoptive parents, and the adoptive parents themselves. The rights of the first three groups have received regular attention from the state legislatures, courts, and commentators; the adoptive parents' rights, however, remain somewhat uncertain despite their central role in the adoption process.[1] An important issue which remains unresolved is what avenues of recourse are available to the adoptive parents when they have been fraudulently induced into the adoption by the party placing the child.

One means of redress which has been available in some jurisdictions is annulment of the adoption.[2] This remedy, however, is severely limited by short statutes of limitations[3] and is generally frowned upon by the courts.[4] One of the primary reasons this remedy is disfavored is that it breaks up the newly created family unit and forces the child to undergo once again a dramatic change in his or her environment.[5] As in all adoption matters, "the primary concern of the courts is the welfare of the child."[6] Courts are hesitant to annul a completed adoption that was

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[1]In the last fifty years, only a few law review articles have focused on the rights of adoptive parents. *See* Note, *Adoption—Abrogation of Adoption*, 16 B.U.L. Rev. 700 (1936); Note, *Abrogation of Adoption by Adoptive Parents*, 19 Fam. L.Q. 155 (Summer 1985); Note, *Annulment of Adoption Decrees on Petition of Adoptive Parents*, 22 J. Fam. L. 549 (1983-84) [hereinafter Note, *Annulment of Adoption*]; Note, *Adoption: Annulment of Status*, 29 Notre Dame Law. 68 (1953-54). State legislatures have given very little attention to the rights of adoptive parents.

[2]*See, e.g.*, Note, *Annulment of Adoption*, *supra* note 1; Annotation, *Annulment or Vacation of Adoption Decree by Adopting Parent or Natural Parent Consenting to Adoption*, 2 A.L.R.2d 887 (1948).

[3]The majority of jurisdictions have limitation periods of one year or less. *See* Note, *Annulment of Adoption, supra* note 1, at 553 app. A.

[4]"Courts have generally recognized or at least assumed that an adoption decree may be annulled at the instance of the adopting parents but indicate reluctance to disturb the status of an adopted child unless the vacating of the decree would clearly be for its best interest." Pierce v. Pierce, 522 S.W.2d 435, 436 (Ky. 1975) (citing Annotation, *supra* note 2, at 887).

[5]The Supreme Court of Minnesota recently wrote, "It is simply not in the best interests of a child for the parent-child relationship to be continually altered. . . . Some serious and compelling reason must exist in order to once again uproot the child and dramatically change his living environment." *In re* Welfare of K.T., 327 N.W.2d 13, 18 (Minn. 1982).

[6]County Dep't of Pub. Welfare v. Morningstar, 128 Ind. App. 688, 697-98, 151 N.E.2d 150, 156 (1958) (en banc).

previously found, through formal adjudication, to be in the best interests of the adopted child.[7]

Recently, however, the Ohio Supreme Court decided a novel case which could pave the way for an alternative remedy in cases where adoptive parents are fraudulently induced into an adoption. In *Burr v. Board of County Commissioners*,[8] the court affirmed an award of $125,000 in compensatory damages to the victims of a "wrongful adoption."[9] The evidence showed that an adoption agency had fraudulently misrepresented the health and background of the prospective adoptee and his natural parents to the prospective adoptive parents, Mr. and Mrs. Burr.[10] Relying on this erroneous information, the couple adopted what they believed to be "a nice big, healthy, baby boy."[11] During the ensuing years, however, their son "suffered from a myriad of physical and mental problems," and developed a genetically transmitted fatal disease.[12] The Burrs eventually learned of the fraud that had been practiced on them, but only after they had incurred tremendous medical expenses for their son.[13] The adoptive parents successfully proved their "wrongful adoption" tort claim, received monetary damages, and the family unit remained intact.[14]

The tort of wrongful adoption, as first advanced in the *Burr* case, provides for compensatory damages for adoptive parents who are fraudulently induced into an adoption. Because the wrongful adoption theory does not alter the family unit, it may be a more suitable remedy

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[7]In dismissing a petition for abrogation of adoption, a New York court wrote:

> The order of adoption and the papers upon which it was granted are in all respects proper and the statutory requirements fully satisfied. The court, at that time, determined on all the facts then before it, that the adoption was for the best moral and temporal interests of the child. There is no justification to now upset this formal adjudication based upon an alleged failure of the natural father, at the time of the adoption, to delineate the alleged mental aberrations of his family.

In re Anonymous, 29 Misc. 2d 580, 582, 213 N.Y.S.2d 10, 13 (1961).

[8]23 Ohio St. 3d 69, 491 N.E.2d 1101 (1986).

[9]*Id.* The term "wrongful adoption" has not been previously used by any appellate court in the nation. To the best of their knowledge, co-counsel for the Burrs were the first to use the term when they labeled their initial pleading as a "Complaint in Fraud and Reimbursement of Expenses for Wrongful Adoption." Telephone interview with Wylan Witte, Esq. (Dec. 8, 1986); Telephone interview with Kenneth Cardinal, Esq. (Feb. 6, 1987). The theory has some similarities to the "wrongful birth" cause of action which has been the subject of much litigation and debate in recent years. The two tort causes of action, however, must be distinguished in that wrongful birth usually involves negligence, whereas wrongful adoption, as used in the *Burr* case and this Note, contemplates the tort of fraud.

[10]*Burr*, 23 Ohio St. 3d at 69, 70, 491 N.E.2d at 1101, 1103.

[11]*Id.* at 70, 491 N.E.2d at 1103.

[12]*Id.*

[13]*Id.* at 71-72, 491 N.E.2d at 1103-04.

[14]*Id.* According to co-counsel for the Burrs, the child is presently receiving extensive treatment at a private nursing home where his parents visit him frequently. Telephone interview with Kenneth Cardinal, Esq. (Feb. 6, 1987).

than annulment in many cases where the adoptive parents are the victims of fraud.[15] In some jurisdictions, it may be the only available remedy where the fraud goes unnoticed for a substantial period of time, because annulment may be barred by a short statute of limitations.[16] The wrongful adoption theory serves a dual purpose in that the rights of the adoptive parents are recognized without infringing upon the best interests of the child. Future acts of adoption fraud are also more likely to be deterred under the wrongful adoption theory because the wrongdoers will be subject to monetary liability for the damages they inflict.

This Note will first discuss the realities of adoption fraud in the United States. It will then examine the differences between annulment and money damages as remedies in these settings; it will discuss when money damages should be available and what interests are promoted by such an award; and it will analyze what the actual measure of damages should be. It will also examine some recent legislative enactments which, because of their potential to deter adoption fraud in the future, should be considered by other jurisdictions. It is the central thesis of this Note that the wrongful adoption theory is a viable cause of action which affords a superior remedy to annulment by protecting the best interests of the child while preserving the heretofore unrecognized rights of the adoptive parents.

II. Fraud in the Adoption Setting

Instances of adoptive parents being fraudulently induced into an adoption are not new in the United States. There have been a number of reported cases at the appellate level involving basically two distinct fact situations.[17] The first line of cases involves fraud between related parties.[18] An example of such a case is *In re Welfare of Alle*,[19] where a stepfather alleged that his wife, the natural mother of the children, fraudulently induced him into formally adopting the children.[20] The evidence showed that while the adoption proceeding was pending, the natural mother was planning to separate from the stepfather and desired the adoption only for financial expediency.[21] Her scheme was apparently to have formal

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[15]There is, of course, nothing to prevent a party from seeking both remedies concurrently if annulment is available in the given jurisdiction. In most cases, however, it would seem that the adoptive parents would tend to choose only one of the two remedies.

[16]For a discussion of limitation periods, see *infra* notes 40-62 and accompanying text.

[17]It is, of course, impossible to determine the number of similar cases that have not left the trial court level. According to Kenneth Cardinal, co-counsel for the Burrs, there are at least two other wrongful adoption cases pending in Ohio trial courts alone. Telephone interview with Kenneth Cardinal, Esq. (Feb. 6, 1987).

[18]This type of adoption is generally referred to as "related adoption" and will be so labeled throughout this Note.

[19]304 Minn. 254, 230 N.W.2d 574 (1975).

[20]*Id.*

[21]*Id.* at 256, 230 N.W.2d at 576.

parental rights established with the stepfather so that she could secure custody payments from him upon separation. The court, in remanding the case for further findings on the issues of fraud and the interests of the children, held that the adoption decree could be set aside if it was found to have been obtained by fraud.[22]

The second line of cases, and the seemingly more tragic of the two, involves fraud between unrelated parties.[23] In this situation, the adoptive parents actively seek to adopt a child from a public or private agency or through an independent intermediary such as a doctor, lawyer, or social worker.[24] The fraud involved usually centers on the health or background of the prospective adoptee.[25] The National Committee for Adoption has

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[22]*Id.* at 257, 230 N.W.2d at 577. For other examples of this type of fraud between related parties, see *In re* Adoption of Hadtrath, 121 Ariz. 606, 592 P.2d 1262 (1979) (en banc); Pierce v. Pierce, 522 S.W.2d 435 (Ky. 1975).

[23]Unrelated adoptions inherently involve greater uncertainty because the adopting parent does not know the health or background of the child as he or she would in a related adoption. Because the potential for fraud and the resultant damage is greater in unrelated adoptions, this Note will be primarily concerned with this situation. The same principles would, to some degree, seem to apply to a wrongful adoption action involving related parties.

[24]"There are a number of ways in which children may be placed in adoptive homes. Three of these placement methods are through a private or public agency, by private arrangement, and through the black market." S. Green & J. Long, Marriage and Family Law Agreements § 5.39 (1984). This Note will be primarily concerned with public and private agency placements as well as independent private placements. Agency placements are everywhere permitted and, as in all adoption matters, are governed by state law. Independent adoptions, also known as private placements or the "gray market," usually involve an intermediary such as a doctor, lawyer, or social worker. *Id.* § 5.41. Independent adoptions may provide the only opportunity for adoption for couples who do not meet agency guidelines.

Although independent adoptions have lately been the subject of much debate and criticism, *see, e.g.*, Note, *Babes and Barristers: Legal Ethics and Lawyer Facilitated Independent Adoptions*, 12 Hofstra L. Rev. 933 (1984); Note, *Independent Adoption: Regulating the Middleman*, 24 Washburn L.J. 327 (1985); *Baby Brokers—How Far Can a Lawyer Go?*, Nat'l L.J., Feb. 9, 1987, at 1, col. 1, this method of adoption is still on the rise and today accounts for nearly one-third of all unrelated adoptions. National Committee for Adoption, Adoption Factbook, United States Data, Issues, Regulations and Resources 13 (Nov. 1985) [hereinafter Adoption Factbook]. The statutes of each jurisdiction must be examined to determine which types of placement are available.

"Due to the shortage in the number of adoptable infants and the delays associated with agency adoptions, some couples have turned to the black market for a child." S. Green & J. Long, *supra*, § 5.42. Black market adoptions, which are illegal in all states, present unique problems beyond the scope of this note. For a discussion of this type of placement, see Turano, *Black-Market Adoptions*, 22 Cath. Law. 48 (1976).

[25]*See, e.g.*, County Dep't of Pub. Welfare v. Morningstar, 128 Ind. App. 688, 151 N.E.2d 150 (1958) (en banc) (misrepresentation of both health and background by an agency); Burr v. Board of County Comm'rs, 23 Ohio St. 3d 69, 491 N.E.2d 1101 (1986) (misrepresentation of both the child's health and background by an agency); Allen v. Allen, 214 Or. 664, 330 P.2d 151 (1958) (allegation of fraud centering on agency's failure to inform of child's mental deficiencies).

noted the risks in this area, writing: "The adoptive parents may not receive full and accurate information about the health issues of the child. Frequently, problems are covered up or not mentioned in the hope that bonding or finalization will take place and the adoptive parents will have no recourse."[26]

Although the instances of fraud in the placement setting are the exception rather than the rule, and although the great majority of public and private placements are successful,[27] there are certain factors present in today's society that make the likelihood of fraud greater than in past times. Adoption as a means of creating a family is once again on the rise in the United States.[28] It is estimated that the number of adoptions in the U.S. in 1982 alone totaled 141,861, of which more than 50,000 were unrelated adoptions.[29] These figures represent a substantial increase from the mid 1970's.[30] The reasons for this increase involve a number of factors such as the large number of couples unable to bear children on their own,[31] as well as the growing number of women who, because of career demands, are unable or unwilling to devote the time required for pregnancy and childbirth. The resultant increased demand for prospective children has led to a growing vulnerability for the adoptive parents who are so anxious to perfect an adoption. It is also noteworthy that independent adoptions, which are considered by many to be more risky to the adoptive parent than agency adoptions,[32] now constitute one-third of all unrelated adoptions.[33] Thus, one would expect that the potential for fraud in today's society is significant for the adopting parent.

Indeed, the presence of fraud in the field of adoption led Senators Jake Garn, Orrin Hatch, and Roger Jepsen to sponsor drastic legislation which was introduced in the United States Senate in 1984 calling for civil and criminal penalties for perpetrators of adoption fraud.[34] The bill, the

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[26] ADOPTION FACTBOOK, *supra* note 24, at 48.

[27] The *Burr* court, noting that there are "many fine adoption programs," directed its opinion to the "rare and fraudulent abuse" of the adoption process. 23 Ohio St. 3d at 69, 78, 491 N.E.2d at 1101, 1109.

[28] Note, *Annulment of Adoption*, *supra* note 1, at 13.

[29] *Id.*

[30] *Id.*

[31] It is estimated that up to fifteen percent of American couples are unable to have children. U.S. NEWS & WORLD REP. Jan. 19, 1987, at 15.

[32] *See* S. GREEN & J. LONG, *supra* note 24, § 5.41; ADOPTION FACTBOOK, *supra* note 24, at 47-48. *But see* Shovers, *Non-Contested Adoptions: Policy, Law, Procedure* 6 (Indiana Continuing Legal Education Forum 1985), where one commentator wrote: "One reason that natural and adoptive parents choose private adoption over state or nonprofit agency adoptions is the degree of control provided by a private adoption. Private adoption offers the opportunity for a complete investigation and recording of medical histories of the child and his natural parents."

[33] ADOPTION FACTBOOK, *supra* note 24, at 13.

[34] The legislation was also supported by Senators Grassley, Denton, Bentsen, Domenici,

Anti-Fraudulent Adoption Practices Act of 1984,[35] was aimed at providing legal protection to adoptive parents and natural mothers who are victimized by fraudulent adoption practices.[36] It called for criminal penalties of up to five years imprisonment and $10,000 for anyone who knowingly and willfully made "any statement" or used "any document known to be false" or who "conceal[ed] or misrepresent[ed] any material fact" in connection with an adoption.[37] In addition, any person harmed by such conduct could bring an action in federal district court for civil damages.[38] Although the bill did not become law,[39] the serious debate and scrutiny it produced demonstrates the potential for fraud that has become an unfortunate reality in adoption proceedings. Because this evil will remain a part of American society for the foreseeable future, it is necessary to analyze the remedies available to the victims of such fraud and to determine which remedy best supports the public interest.

III. Annulment as a Remedy

Instances in which adoptive parents seek to annul an adoption decree are usually infrequent because the relationship is entered into voluntarily and with foresight of potential consequences.[40] Where fraud is used to induce adoptive parents into the relationship, however, the process loses its voluntary nature in that the adoptive parents would probably not be willing to proceed if they were aware of the likelihood of future physical, mental, or emotional problems with the child. Because adoption is "a statutory process with restrictions and requirements that vary from state to state,"[41] the statutes of the jurisdiction involved must first be examined

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Kasten, and Huddleston. It was introduced in the House by Congressmen Jack Brooks and Pat Roberts. *The Anti-Fraudulent Adoption Practices Act of 1984: Hearings on S. 2299 Before the Subcomm. on Courts of the Sen. Comm. on the Judiciary*, 98th Cong., 2d Sess. 72 (1984) [hereinafter *Senate Hearing*].

[35]S. 2299, 98th Cong. 2d Sess. (1984).

[36]Senator Roger Jepsen stated, "This act would provide legal protection to adoptive parents and mothers who have been victimized by fraudulent adoption practices." *Senate Hearing*, *supra* note 34, at 3 (statement of Sen. Roger Jepsen). Senator Grassley noted, "As the number of available children for adoption drop, anxious families become the easy prey of scam operations. The legislation before us would impose the appropriate sanctions in cases of adoption fraud." *Id.* at 26 (statement of Sen. Charles Grassley).

[37]S. 2299, 98th Cong., 2d Sess. (1984).

[38]*Id.*

[39]The bill was criticized by the Justice Department on a number of grounds. The Department asserted that existing criminal statutes adequately provided an avenue for prosecution for adoption fraud, that the bill would prove difficult to enforce, and that "the section would punish the knowing use of false, non-material information as severely as the concealment of a material fact," which would be a "marked departure from the language of other false statement statutes . . . ." *Senate Hearing supra* note 34, at 48-54.

[40]Note, *Annulment of Adoption*, *supra* note 1, at 549.

[41]S. Green & J. Long, *supra* note 24, § 5.39.

to see if they provide adoptive parents with the right to petition for annulment.[42]

The recent trend in state legislatures, as a result of the policy of stability in the family relationship[43] and the emphasis on the welfare of the child,[44] is to make no provision for annulment of the adoption.[45] In states that do specifically provide for this remedy, the action may generally be brought only within a relatively short period of time following entry of the final decree.[46]

Today, only New York[47] and Hawaii[48] specifically provide for annulment in their adoption statutes in cases of fraud involving adoption. These states are in the minority in that they do not contain limitation periods on such an action.[49] The majority of jurisdictions impose a short limitation period ranging from twenty days[50] to two years[51] on an action to set aside an adoption for any reason including fraud.[52] Moreover, today only California provides for annulment of adoption decrees on the separate ground of discovery of certain illnesses arising from conditions that existed prior to the adoption;[53] all other statutes that allowed annulment on these grounds have been repealed.[54] Thus, the availability of annulment to the adoptive parent is severely limited by statute in the overwhelming majority of jurisdictions.

In the absence of explicit statutory grounds or in cases in which the statute of limitations has expired, annulment may be available in some jurisdictions by invoking the inherent power of a court to set aside its own decree. In Indiana, for instance, the adoption statutes do not ad-

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[42]*See* Note, *Annulment of Adoption*, *supra* note 1, at 550 app. A.

[43]"[T]he overall implication of [a survey of the states' adoption statutes] is widespread recognition of the necessity of finalizing the familial status created by an adoption decree." *Id.* at 563.

[44]"The best interests of the child are of primary concern in the adoption process." S. GREEN & J. LONG, *supra* note 24, § 5.39. "[T]he law must make the child's needs paramount [in adoption]." J. GOLDSTEIN, A. FREUD & A. SOLNIT, BEYOND THE BEST INTERESTS OF THE CHILD 7 (1979). Most state adoption statutes mandate that the best interests of the child be considered first and foremost in all adoption matters. For instance, Indiana's adoption statue provides that a petition for adoption shall not be granted unless the court finds that "the adoption prayed for is for the best interest of the child." IND. CODE § 31-3-1-8(a) (1982).

[45]S. GREEN & J. LONG, *supra* note 24, § 5.44; *see also* Note, *Annulment of Adoption*, *supra* note 1, at app. A.

[46]M. LEAVY & R. WEINBERG, LAW OF ADOPTION 63 (1979).

[47]N.Y. DOM. REL. LAW § 114 (McKinney 1977).

[48]HAWAII REV. STAT. § 578-12 (1976).

[49]*See* HAWAII REV. STAT. § 578-12 (1976); N.Y. DOM. REL. LAW § 114 (McKinney 1977).

[50]*See* MICH. COMP. LAWS. ANN. § 710.64(1) (West Supp. 1986).

[51]*See* NEB. REV. STAT. § 43-116 (1984).

[52]*See* Note, *Annulment of Adoption*, *supra* note 1, at app. A.

[53]CAL. CIV. CODE § 227b (West 1982).

[54]Note, *Annulment of Adoption*, *supra* note 1, at 554.

dress the manner or availability of annulment.[55] Indiana courts, however, have recognized that "[a] decree of adoption may be vacated upon such grounds as would entitle the court to vacate any other order or decree."[56] "[A] decree of adoption may be vacated by a petition to the court which entered it [where] fraud [is used] in obtaining [the decree]."[57]

A number of jurisdictions, however, hold that the right to set aside an adoption decree must be legislatively provided.[58] For example, in *Allen v. Allen*,[59] the Oregon Supreme Court held that absent statutory authority on the subject, the adoptive parents have no right to set aside adoptions, even in cases of fraud.[60] The court cited with approval the rule set forth in an earlier Tennessee case:[61]

> Where one voluntarily assumes the relationship of parent to a child by formal adoption, it cannot be lightly cast aside. The relationship involves duties of care, maintenance and education with rights of custody, control and service of the child. Society has an interest in this relationship, and we think the Legislature alone should supply the procedure to be followed, as well as define the cause, if any, whereby the relationship may be dissolved. In the absence of such a statute the courts will not assume jurisdiction to annul a decree of adoption at the instance of the adopting parent and cast the child adrift to again become a public charge.[62]

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[55]Indiana's adoption statute, found at Ind. Code § 31-3-1-1 (Supp. 1986), is silent on annulment.

[56]State v. Probate Court, 225 Ind. 268, 274, 73 N.E.2d 769, 772 (1947); *see also* County Dep't of Pub. Welfare v. Morningstar, 128 Ind. App. 688, 151 N.E.2d 150 (1958) (en banc).

[57]State v. Probate Court, 225 Ind. at 274, 73 N.E.2d at 772 (quoting 1 Am. Jur. *Adoption of Children* § 72 (1936)). "Although the action is a rare one, there is nothing to prevent a court of competent jurisdiction from directly vacating an order of adoption under proper circumstances, as where entry of the decree was brought about by fraud, misrepresentation, or undue influence." *In re* Welfare of Alle, 304 Minn. 254, 257, 230 N.W.2d 574, 577 (1975).

[58]*See* Note, *Annulment of Adoption*, *supra* note 1, at 550.

[59]214 Or. 664, 330 P.2d 151 (1958). The *Allen* case is unique in that it is the only reported case other than *Burr* in which monetary damages were sought for the fraud allegedly practiced upon the adoptive parents by the home that placed the child. *Id.* at 667, 330 P.2d at 154. The adoptive parents in *Allen* were unsuccessful in their claim for annulment and money damages on both jurisdictional and substantive grounds. *Id.*

[60]*Id.* In dicta the court seemed to indicate that equity would allow annulment if the best interests of the child were at stake. The court noted, "It is recognized that a court of general equity jurisdiction may set aside a decree of adoption. . . . It is to be carefully noted . . . that equity will assert this authority only to protect the *best interest and welfare of the child*. In this case there is no allegation that the best interests or welfare of the child . . . is at stake." *Id.* at 667, 330 P.2d at 154. (emphasis in original, citation omitted).

[61]Coonradt v. Sailors, 186 Tenn. 294, 209 S.W.2d 859 (1948).

[62]*Id.* at 296, 209 S.W.2d at 861.

More recently, the Arizona Supreme Court decided *In re Adoption of Hadtrath*,[63] holding that although rule 60(c)(3) of Arizona's Rules of Civil Procedure[64] allows relief from judgment on grounds of fraud, such relief is available only when a timely motion has been made.[65] The court noted that "an allegation of fraud does not attack the court's jurisdiction to decide a case. Consequently a judgment obtained by fraud is not void but merely voidable. For this reason timeliness becomes an important concern."[66] Since the motion for relief in the *Hadtrath* case was filed after the six-month time limit of rule 60(c)(3), the court upheld the dismissal of the motion as untimely.[67]

These and other cases[68] illustrate the disfavor accorded actions to annul adoption decrees. Annulment is a drastic measure which breaks up the family unit and severs the child's ties with the only parents he has. The majority of criticisms leveled at this remedy have focused on the harsh effects it has on the adopted child.[69]

There are, however, other faults of annulment which are important. This remedy, where available, is restricted by short limitation periods in the majority of jurisdictions.[70] Yet where fraud is involved, it is very likely that the adoptive parents will not learn of the misrepresentations until well after the time for annulment has passed.[71] One court recently described this problem:

> By its nature, fraud involves deception, which may not come to light during the year following entry of the decree. Duress and undue influence, however, do not depend on deception, but rather on the overcoming of one's free will. In our view, it is likely

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[63]121 Ariz. 606, 592 P.2d 1262 (1979) (en banc).

[64]ARIZ. R. CIV. P. 60(c)(3).

[65]121 Ariz. at 610, 592 P.2d at 1266.

[66]*Id.* at 610, 592 P.2d at 1265-66.

[67]*Id.*

[68]*See, e.g., In re* Adoption of Hobson, 8 Kan. App. 2d 772, 777, 667 P.2d 911, 915 (1983) ("Courts should now allow abrogation of an adoption if it is premised on the desire of adoptive parents to rid themselves of a bad bargain, or because of a mere change in attitude or regret."); *In re* Anonymous, 29 Misc. 2d 580, 582, 213 N.Y.S.2d 10, 14 (1961) ("[T]he fraud which will suffice to vacate an order or judgment [of adoption] must be fraud in the very means by which the judgment was procured.").

[69]"It is not uncommon for courts to deny an annulment, even when there is evidence supporting a valid ground for annulment, if the annulment would not serve the best interest of the child." Note, *Annulment of Adoption*, *supra* note 1, at 562.

[70]*See supra* text accompanying notes 3 and 4.

[71]For instance, in Burr v. Board of County Commissioners, 23 Ohio St. 3d 69, 491 N.E.2d 1101 (1986), the adoptive parents did not learn of the fraud for some eighteen years. Similarly, in County Department of Public Welfare v. Morningstar, 128 Ind. App. 688, 151 N.E.2d 150 (1958) (en banc), the adoptive parents did not learn of the fraud practiced on them by the county agency for two years.

> that the victims of duress or undue influence will become aware of their victimization within a year, if ever. *A victim of fraud, however, might not.*[72]

Still another downfall of the remedy is its inherent lack of deterrent value against future fraudulent practices. If, for instance, an adoption home misrepresents a child's background as occurred in *Burr*, an annulment proceeding merely requires the home to take over the care of the child until another adoption is perfected. Although this may inconvenience the home and force it to incur additional expense and paperwork, it is unlikely that it will bring about increased scrutiny of potential future abuses.[73]

Thus, annulment as a remedy for adoptive parents is available in many jurisdictions, but only to a limited degree. It has been and will remain an unpopular remedy because of its harsh effects on the child, its limited availability to adoptive parents where they are fortunate enough to discover the fraud in time, and its inherent lack of deterrent value against future misrepresentation. Because of these drawbacks, the alternative remedy of awarding compensatory damages through the wrongful adoption theory requires serious consideration and evaluation.

IV. Wrongful Adoption—*Burr v. Board of County Commissioners*

In the first reported case of its kind, the Supreme Court of Ohio, in *Burr v. Board of County Commissioners*,[74] affirmed an award of money damages to adoptive parents who were fraudulently induced into an adoption.[75] In 1964, Russell and Betty Burr contacted the Stark County Welfare

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[72]*In re* Adoption of Male Minor Child, 619 P.2d 1092, 1097 (Haw. Ct. App. 1980) (emphasis added).

[73]In annulments of independent adoptions, it is not entirely clear what would become of the child. It seems likely that the child would become a ward of the state until another placement was perfected.

[74]23 Ohio St. 3d 69, 491 N.E.2d 1101 (1986).

[75]*Id. Burr* is unique in that it is the first reported award of monetary damages to adoptive parents who were victims of fraud. Two earlier cases had strikingly similar fact patterns, but did not involve an award of compensatory damages. In County Department of Public Welfare v. Morningstar, 128 Ind. App. 688, 151 N.E.2d 150 (1958) (en banc), the county agency falsely represented to the adoptive parents that the prospective child was of good physical and mental health and that the natural parents were of good health and character. Several years after the adoption was perfected, the young child began to display severe problems, including violent tantrums and serious sexual abnormalities. An annulment of the adoption decree was permitted when it was learned that the agency had misrepresented the fact that the natural father was an immoral man who had committed incest with his daughters. It was also learned that the natural mother had lived a life of sexual promiscuity, one of the older sisters had lived an immoral life for several years, and another sister was feeble-minded. The court allowed annulment on the grounds that a "tragic fraud" had been perpetrated on the adoptive parents. *Id.*

Similarly, in Allen v. Allen, 214 Or. 664, 330 P.2d 151 (1958), the adoptive parents

Department expressing their desire to adopt a child. The Burrs were initially informed that such a placement could take over a year to complete, but were subsequently told by an employee of the department that a seventeen-month-old boy was available for adoption. The Burrs met the county case-worker and were informed that

> the infant was borne by an eighteen-year-old mother, that the mother was living with her parents, that the mother was trying to take care of the child and trying to work during the day, that the grandparents were mean to the child, that the mother was going to Texas for better employment, and that she had surrendered the child to [the department] for adoption.[76]

Russell Burr testified that the case-worker represented to them that the child "was a nice big, healthy, baby boy" who had been born at the Massillon City Hospital.[77] The Burrs proceeded with the adoption unaware of any risks, and the child, Patrick, became a legal member of the family.

During the ensuing years, however, "Patrick suffered from a myriad of physical and mental problems,"[78] including "[p]hysical twitching, speech impediment, poor motor skills, and learning disabilities"[79] which eventually led him to be classified as E.M.R. (educable mentally retarded) during primary school. Despite special education classes and special care by the Burrs, Patrick's condition degenerated over the following years. By high school, he was observed to suffer from hallucinations and was admitted to several hospitals for diagnosis and treatment.

Eventually Patrick was diagnosed as suffering from Huntington's disease, a genetically inherited fatal disease which attacks the central nervous system.[80] The Burrs incurred medical expenses in excess of $80,000 for treatment of this disease alone. During the course of treatment for this disease, the Burrs obtained a court order opening the sealed records

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alleged that a private placement agency had misrepresented the child's mental deficiencies, which became apparent as the child developed. The adoptive parents sought annulment of the decree as well as monetary damages for expenses incurred in the treatment of their child. The court ruled that annulment was not possible due to lack of jurisdiction and also noted that a case for fraud had not been proven. One justice dissented, noting that the private agency's conduct constituted fraud. The dissent, however, did not comment on whether compensatory damages would have been available. *Id.*

[76] *Burr*, 23 Ohio St. 3d at 70, 491 N.E.2d at 1103.

[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] *Id.* Huntington's disease is "a rare hereditary disease characterized by chronic progressive chorea (ceaseless involuntary movements) and mental deterioration terminating in dementia; the age of onset is variable but usually occurs in the fourth decade of life. Death usually follows within fifteen years. It is transmitted as an autosomal dominant trait." DORLAND'S ILLUSTRATED MEDICAL DICTIONARY 264 (26th ed. 1985).

concerning his background prior to adoption in order to learn whether Patrick's problems might have been hereditary.[81]

From these records, the Burrs first learned in 1982 that the county case-worker had egregiously misrepresented the health and background of the child. The court summarized the extent of the fraud, writing:

> These previously sealed records revealed that Patrick's mother was actually a thirty-one-year old mental patient at the Massillon State Hospital. Patrick had not been born at Massillon City Hospital, but rather was delivered at the state mental institution. The father's identity was unknown, but he was presumed to also have been a mental patient. Patrick's biological mother shared his low intellectual level and also had a speech impediment. She was diagnosed as having a 'mild mental deficiency, idiopathic,[82] with psychotic reactions . . . . The records also showed that Patrick suffered a fever at birth, and was known by appellants to be developing slowly. A series of psychological assessments was conducted by [the department] prior to adoption, some of which . . . indicated that the boy was functioning at a lower intellectual level than his chronological age.[83]

In affirming the trial court's award of $125,000 in compensatory damages to the Burrs, the court held that the essential elements of fraud had been established by the adoptive parents in their wrongful adoption case.[84] The court noted that the Burrs justifiably relied on the misrepresen-

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[81]*Burr*, 23 Ohio St. 3d at 71, 491 N.E.2d at 1104. "Practically all states now provide for making adoption proceeding records secret and available for inspection only by court order." M. Leavy & R. Weinberg, *supra* note 46, at 64. "The majority of states require a showing of good cause before access is granted. Examples of good cause include an adoptee's need for medical information or an adoptee's desire to claim an inheritance. Some states allow disclosure only if it will promote or protect the welfare of the adoptee, while other states have no disclosure requirements other than a court order. Some state statutes provide an adoptee with an absolute right to inspect adoption records." S. Green & J. Long, *supra* note 24, § 5.49. In the instant case, the Burrs were required under Ohio law to get court permission to inspect the sealed records. *See* Ohio Rev. Code Ann. § 3107.17 (Page 1980).

The sealed record controversy has been the subject of a wealth of commentary. *See generally* Glosband, *The Rights of Adopted Children*, 17 Trial 42 (1981); Levin, *The Adoption Trilemma: The Adult Adoptee's Emerging Search for His Ancestral Identity*, 8 U. Balt. L. Rev. 496 (1979); Note, *Sealed Adoption Records and the Constitutional Right of Privacy of the Natural Parent*, 34 Rutgers L. Rev. 451 (1982).

[82]"The term 'idiopathic' denotes 'a disease of unknown cause.'" *Burr*, 23 Ohio St. 3d at 71 n.1, 491 N.E.2d at 1104 n.1 (citation omitted).

[83]*Id.* at 71, 491 N.E.2d at 1104.

[84]*Id.* at 73, 491 N.E.2d at 1105. The court listed the elements of fraud as:

(a) a representation or, where there is a duty to disclose, concealment of a fact,
(b) which is material to the transaction at hand,
(c) made falsely, with knowledge of its falsity, or with such utter disregard and

tations made to them, and wrote that "[i]t would be a travesty of justice and a distortion of the truth to conclude that deceitful placement of this infant, known by appellants to be at risk, was not actionable when the tragic but hidden realities of the child's infirmities finally came to light."[85]

Burr is novel in that it is the first reported case of its kind involving compensatory damages rather than annulment of the adoption in a fraud setting. The fact that the Burrs did not discover the fraud until eighteen years after the decree barred any action for annulment because Ohio does not allow an adoption to be set aside after one year for any grounds including fraud.[86] Fortunately for the Burrs, however, Ohio's four-year statute of limitations for fraud tort suits does not begin to run until the date the fraud is discovered.[87] Had the same case arisen in a state such as Indiana where the period runs from the date the fraud was committed,[88] the wrongful adoption suit would have been time barred. Despite the thorough treatment given by the court to this and the other issues it faced, there remain a number of unanswered questions regarding the wrongful adoption tort theory.

V. Standards for Recovery in Wrongful Adoption—Would Mere Nondisclosure Be Actionable?

The *Burr* court, while allowing recovery for wrongful adoption, emphasized that the basis of its decision was the deliberate and active fraud practiced upon the adoptive parents.[89] The question arises, then, whether a wrongful adoption suit could lie where the party placing the child merely withheld such vital information without actively misrepresenting any facts. At first reading, the *Burr* opinion seems to indicate that mere nondisclosure would not have been sufficient for recovery. The court stated:

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recklessness as to whether it is true or false that knowledge may be inferred,
(d) with the intent of misleading another into relying upon it,
(e) justifiable reliance upon the representation or concealment, and
(f) a resulting injury proximately caused by the reliance.

Id. (quoting Cohen v. Lamko, Inc., 10 Ohio St. 3d 167, 169, 462 N.E.2d 407, 409 (1984) (quoting Friedland v. Lipman, 68 Ohio App. 2d 255, 429 N.E.2d 456 (1980)), paragraph one of the syllabus).

[85] *Id.* at 73, 491 N.E.2d at 1107.

[86] Ohio Rev. Code Ann. § 3107.16(B) (Page 1980).

[87] *Id.* § 2305.09. The statute specifically provides that the four-year period for fraud "shall not accrue . . . until the fraud is discovered." *Id.*

[88] Ind. Code § 34-1-2-1 (1982) provides that actions for relief against fraud "shall be commenced within six years after the cause of action has accrued, and not afterwards." Indiana courts have held that a cause of action accrues and the statute of limitations begins to run on the date the fraud is perpetrated. *See, e.g.*, Estate of Ballard v. Ballard, 434 N.E.2d 136 (Ind. Ct. App. 1982); Forth v. Forth, 409 N.E.2d 641 (Ind. Ct. App. 1980).

[89] 23 Ohio St. 3d at 76, 77-78, 491 N.E.2d at 1108, 1109.

> We believe it appropriate to comment briefly concerning the breadth of today's decision. In no way do we imply that adoption agencies are the guarantors of their placements. Such a view would be tantamount to imposing an untenable contract of insurance that each child adopted would mature to be healthy and happy. Such matters are solely in the hands of a higher authority. It is not the mere failure to disclose the risks inherent in this child's background which we hold to be actionable. Rather, it is the deliberate act of misinforming this couple which deprived them of their right to make a sound parenting decision and which led to the compensable injuries.[90]

From this language, then, it initially appears that the Burrs' claim could not have been maintained had the agency merely failed to disclose the background of the child.

A closer reading of the case, however, and a study of the law relating to the duty of disclosure, raises some doubts on this issue. What the court actually seemed to hold is that sovereign immunity might have barred an action against the state agency if the action had been premised on the department's policy of silence, not that such an action for nondisclosure could not lie in any scenario.

Apparently the state agency had a policy in effect in 1964 not to share personal histories of the children with the adoptive parents.[91] The agency argued that this policy decision not to disclose histories was the type of decision protected by the doctrine of sovereign immunity.[92] In rejecting this argument, the court wrote:

> We find that sovereign immunity does not preclude this cause of action. *The suit is premised not on injuries resulting from [the agency's] official policy of silence, but rather on [the agency's] active and knowing misrepresentation of fact.* . . . [W]e conclude in this case that the doctrine of sovereign immunity does not shield a political subdivision from responsibility for the fraudulent acts and misrepresentations of its employees . . . .[93]

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[90] *Id.* at 77-78, 491 N.E.2d at 1109.

[91] In its special verdict, the jury in the *Burr* case specifically found that the department had a policy "not to disclose to adoptive parents the family history of children being adopted." *Id.* at 77 n.5, 491 N.E.2d at 1108 n.5.

[92] The county welfare department's argument went as follows:

> The policy decision of the adoption division . . . that family history of children being placed for adoption not be disclosed to adoptive parents is the type of policy decision that provides sovereign immunity protection from claims by adoptive parents for damages . . . alleged to result from the failure of personnel . . . to disclose the family history . . . in the absence of an allegation and in the absence of proof of negligence in the manner which the policy was implemented.

Brief for Defendant-Appellants at 15, *Burr*, 23 Ohio St. 3d 69, 491 N.E.2d 1101.

[93] *Burr*, 23 Ohio St. 3d at 77, 491 N.E.2d at 1108 (emphasis added).

Thus, the court's words that "it is not the mere failure to disclose . . . which we hold to be actionable"[94] may well be dicta since the adoptive parents' suit was premised on active misrepresentation rather than on the policy of silence.[95]

Support for this interpretation and the proposition that a mere failure to disclose such information might be actionable is found earlier in the opinion where the court listed the first of the four elements of fraud as "a representation or, *where there is a duty to disclose, concealment of a fact*."[96] Indeed, it has long been recognized that actual fraud is committed if "either party to a transaction conceals some fact which is material, which is within his own knowledge, *and which it is his duty to disclose* . . . ."[97] This rule is firmly entrenched today in case law[98] and has been embraced by the drafters of the *Restatement (Second) of Torts*.[99] Nondisclosure, then, is clearly actionable if a duty to disclose exists. The central question, then, is whether such a duty arises in connection with the placement of a prospective adoptee.

Whether such a duty exists has been regarded as a question of law for the courts rather than for the jury.[100] As early as 1882, one authority had delineated the circumstances in which this duty arises into three distinct classes.[101] The first group "includes all those instances in which . . . there is a previous, existing, definite fiduciary obligation between the parties; so that the obligation of perfect good faith and of complete disclosure always arises from the existing relations of trust and confidence . . . .[102]

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[94]*Id.* at 78, 491 N.E.2d at 1109.

[95]*Id.* at 76-77, 491 N.E.2d at 1108.

[96]*Id.* at 73, 491 N.E.2d at 1105 (emphasis added).

[97]11 J. Pomeroy, Equity Jurisprudence 389 (1882) (emphasis in original).

[98]*See, e.g.*, McMahon v. Meredith Corp., 595 F.2d 433, 438 (8th Cir. 1979) ("A failure to disclose a material fact can be considered to be an implicit representation of the nonexistence of such fact on which a party may rely, but only if the alleged fraud-feasor has a duty to speak."); Citizens State Bank, Moundridge v. Gilmore, 226 Kan. 662, 666, 603 P.2d 605, 610 (1979) ("[I]t should be pointed out that fraudulent misrepresentation not only includes affirmative acts and misstatements of fact but also the concealment of acts and/or facts which legally or equitably should be revealed."); Miles v. McSwegin, 58 Ohio St. 2d 97, 99, 388 N.E.2d 1367, 1369 (1979) ("It is well established that an action for fraud and deceit is maintainable not only as a result of affirmative misrepresentations, but also for negative ones, such as the failure of a party to a transaction to fully disclose facts of a material nature where there exists a duty to speak."); *In re* Greene, 290 Or. 291, 294, 620 P.2d 1379, 1383 (1980) ("A half-truth or silence can be as much a misrepresentation as a lie.").

[99]*See* Restatement (Second) of Torts §§ 550, 551 (1980).

[100]W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on The Law of Torts 739 (5th ed. 1984) [hereinafter Prosser and Keeton].

[101]J. Pomeroy, *supra* note 97, at 391. These classes remain valid today, although the recent trend has been more towards finding such a duty to exist. *See* Note, *Misrepresentation—Part II*, 37 Md. L. Rev. 523-27 (1978).

[102]J. Pomeroy, *supra* note 97, at 391-92. More recently, the United States Supreme Court succinctly stated that "the duty to disclose arises when one party has information

Familiar examples [of this first group] are contracts and other transactions between a principal and agent, a client and attorney, a beneficiary and trustee, a ward and guardian, and the like."[103] In most situations, the party placing the child would not seem to stand in a fiduciary relationship to the prospective parents;[104] thus, the duty to disclose must originate elsewhere.

Such a duty, however, may be found under the second and third groups of cases. The second class embraces

> those instances in which there is no special fiduciary relation between the parties, and the transaction is not in its essential nature fiduciary, but it appears that either one or each of the parties . . . *expressly* reposes a trust and confidence in the other; or else from the circumstances of the case, the nature of their dealings, or their position towards each other, such a trust and confidence in the particular case is *necessarily* implied. The third class includes those instances where there is no existing fiduciary relation . . . and no *special* confidence reposed . . . , but the very . . . transaction itself, in its essential nature, is intrinsically fiduciary, and necessarily calls for perfect and full disclosure.[105]

In cases such as *Burr*, there can be little doubt that the adoptive parents repose a trust and confidence in the party placing the child because that party, in most situations, has superior knowledge of the child's condition and background.[106] This is necessarily so in many cases because before the adoption the natural parents' and child's records are in the possession and control of the party placing the child, and the records are then sealed by court order upon entry of a final decree.[107] In cases such as this where "one party has superior knowledge not within the fair and reasonable reach of the other party,"[108] a duty to disclose should be found.[109]

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that the other party is entitled to because of a fiduciary or other similar relation of trust and confidence between them." Chiarella v. United States, 445 U.S. 222, 228 (1980).

[103]J. Pomeroy, *supra* note 97, at 392.

[104]Attorneys or other intermediaries in an independent placement, however, may find such a fiduciary duty imposed upon them. It is often unclear in these cases who the intermediary is actually representing. *See* Note, *Babes and Barristers: Legal Ethics and Lawyer-Facilitated Independent Adoptions*, 12 Hofstra L. Rev. 933 (1984).

[105]J. Pomeroy, *supra* note 97, at 389 (emphasis in the original).

[106]"The classic illustration of fraud is where one party having superior knowledge intentionally fails to disclose a material fact . . . which is not discoverable by ordinary observation . . . ." Nessim v. DeLoache, 384 So. 2d 1341, 1344 (Fla. Dist. Ct. App. 1980) (citations omitted).

[107]*See supra* note 81 for discussion of sealed records.

[108]McMahon v. Meredith Corp., 595 F.2d 433, 439 (8th Cir. 1979).

[109]It is perhaps because of this superior knowledge that a few states have recently enacted

Beyond this, the late Dean Prosser noted that "there has been a rather amorphous tendency on the part of most courts in recent years to find a duty of disclosure when the circumstances are such that the failure to disclose something would violate a standard requiring conformity to what the ordinary ethical person would have disclosed."[110] The argument can certainly be made that a party failing to inform adoptive parents about known risks of a prospective adoptive placement violates standards to which the orginary ethical person would conform. Moreover, the welfare of the child, which is the paramount concern in any adoption issue,[111] would seem to be best served where the adoptive parents are fully apprised of known risks about the child. Cognizant of such risks, the adoptive parents would be more able to deal with the emotional hardships which might result when the risks become reality.[112] Thus, a strong argument exists for finding a duty to disclose and allowing recovery in wrongful adoption cases where the party placing the child fails to disclose known risks and injury results.

Allowing recovery in such situations will not make agencies or others who place children through independent channels the "guarantors of their placements."[113] Adoptive parents will be able to recover only when they can prove actual fraud or a failure to disclose known material facts. The *Burr* court's warnings that the child's future health and happiness are "in the hands of a higher authority"[114] are well taken. An illustration of this point is found in *In re Adoption of G*,[115] where the prospective adoptive parents sought to adopt a baby girl who appeared to be in good condition prior to the adoption. The placement agency had a pediatrician and a psychologist conduct several examinations of the child, and no problems were apparent at that time. Some time after the adoption, however, the child began to show signs of slow development, and the adoptive parents, upon taking her to a specialist in pediatric neurology, discovered that the baby was retarded to such a degree that she would eventually require commitment to an institution.

The adoptive parents' petition to vacate the adoption was denied on the grounds that "the law recognizes no distinction between an adoptive

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statutes requiring full disclosure of medical histories to prospective adoptive parents. *See infra* text accompanying notes 142-54 for a discussion of mandatory disclosure laws.

[110] PROSSER AND KEETON, *supra* note 100, at 739.

[111] *See supra* note 44 for a discussion of concern for the child's best interests.

[112] As noted by one commentator, "[C]omplete investigation and recording of medical histories of the child and his natural parents . . . allows the adoptive parents to prepare for any special needs the child may develop." Shovers, *Non-Contested Adoptions: Policy, Law, Procedure* 6 (Indiana Continuing Legal Education Forum 1985).

[113] *Burr*, 23 Ohio St. 3d at 77, 491 N.E.2d at 1109.

[114] *Id.*

[115] 89 N.J. Super. 276, 214 A.2d 549 (1965).

parent and child and a child's relationship to its natural parents."[116] The adoptive parents, like many natural parents, were simply not as fortunate as other parents who are blessed with children having no physical or developmental deficiencies. The agency in *Adoption of G* did not actively misrepresent or fail to disclose any material facts concerning the child; thus, a wrongful adoption tort action would have failed. In short, the fact that the adoptive parents' child turned out to be mentally retarded was something beyond human control.

Such a case illustrates well the principle that recognition of the wrongful adoption theory will not serve to make those placing children guarantors of their placements. Just as there are risks and benefits inherent in becoming natural parents, so too are there risks and benefits present in the adoption process. It is only when those placing the child are cognizant of material facts about the child or her background, when such facts are concealed or misrepresented to the adoptive parents, and when the adoptive parents' detrimental reliance is justified, that an action for wrongful adoption will lie. Any further extension of the doctrine would indeed have an "adverse effect on the [states'] many fine adoption programs."[117]

VI. The Appropriate Measure of Damages

In affirming the trial court's damage award, the *Burr* court noted that the "judgment and award ($125,000) were appropriate in light of the evidence presented to the jury, medical bills ($81,000), other expenses, and [the adoptive parents'] claimed emotional damages."[118] Beyond this brief statement, the opinion does not indicate how the jury computed the damages it awarded. Apparently the agency failed to argue for an offset of the damages in an amount equal to the benefits conferred on the parents through the loving relationship they developed with Patrick despite his problems.[119] The relatively small size of the verdict in consideration of the amount of special damages and claimed emotional damages, however, indicates that the jury may well have taken such benefits into account in its verdict without being instructed to do so.[120]

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[116]*Id.* at 277, 214 A.2d at 550.

[117]*Burr*, 23 Ohio St. 3d at 78, 491 N.E.2d at 1109.

[118]*Id.* at 77, 491 N.E.2d at 1108.

[119]Counsel for the adoptive parents indicated that both parents openly expressed their love for their child in their court testimony, but noted that the defense attempted to use such testimony to its advantage for only a brief period of examination during the trial. Telephone interview with Wylan Witte, Esq. (Dec. 8, 1986); Telephone interview with Ken Cardinal, Esq. (Feb. 6, 1987).

[120]Counsel for the Burrs polled the jurors after the trial and learned that the jury had initially talked of awarding a substantially larger sum. The exact reasons for the smaller,

Such an offset, it could be argued, might fall into the auspices of the "benefit rule" of section 920 of the Restatement (Second) of Torts, which provides:

> When the defendant's tortious conduct has caused harm to the plaintiff or to his property and in so doing has conferred a special benefit to the interest of the plaintiff that was harmed, the value of the benefit conferred is considered in mitigation of damages, to the extent that this is equitable.[121]

This principle has recently been a subject of intense litigation in the growing number of "wrongful birth" or "wrongful conception" cases.[122] These cases typically involve negligent sterilizations or vasectomies which result in unwanted pregnancy and eventual birth.[123] One of the controversial issues in these cases is the proper measure of damages for the parents who have been wrongfully blessed with an unplanned child.[124] "While the courts are now in general agreement that the costs, expenses and pain directly attributable to the pregnancy and childbirth should be recoverable, the question of whether to allow child-rearing expenses remains an issue of fertile debate."[125]

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modest award are not entirely clear. Telephone interview with Wylan Witte, Esq. (Dec. 8, 1986).

[121]RESTATEMENT (SECOND) OF TORTS § 920 (1980).

[122]The amount of litigation and commentary in this area has increased dramatically since the landmark "wrongful birth" case of Custodio v. Bauer, 251 Cal. App. 2d 303, 59 Cal. Rptr. 463 (1967). The term "wrongful birth" is generally used to refer to a negligence action "brought by a member of the infant's family on allegations attributing the infant's unplanned or unwanted birth to the tortfeasor's misfeasance." Annotation, *Tort Liability for Wrongfully Causing One to Be Born*, 83 A.L.R.3d 15, 19 n.4 (1978). This should be distinguished from the term "wrongful life," which is typically used to refer to the infant's own action for being wrongfully brought into the world. *Id.* at 19 n.3. Wrongful birth actions are increasingly recognized as a valid cause of action, whereas wrongful life actions are typically rejected on the basis that it is illogical for a being to argue that his or her own birth has harmed him. *Id.*

For various discussions of this interesting and rapidly developing area of the law, see Kashi, *The Case of the Unwanted Blessing: Wrongful Life*, 31 U. MIAMI L. REV. 1409 (1977); Note, *Wrongful Birth, A Child of Tort Comes of Age*, 50 U. CIN. L. REV. 65 (1981); Comment, *Liability for Failure of Birth Control Methods*, 76 COLUM. L. REV. 1187 (1976); Comment, *Recovery of Childbearing Expenses in Wrongful Birth Cases: A Motivational Analysis*, 32 EMORY L.J. 1167 (1983).

[123]*See, e.g.*, Ochs v. Borrelli, 187 Conn. 253, 445 A.2d 883 (1982) (negligent sterilization); Weintraub v. Brown, 93 A.D.2d 339, 470 N.Y.S.2d 634 (1983) (negligent vasectomy). Other cases have involved negligent misfilling of prescriptions for birth control tablets or a failure to diagnose a woman's pregnancy. *See generally* Annotation, *supra* note 122.

[124]The late Dean Prosser noted, with a likely pun intended, that "the question of how the parent's damages should be determined has become pregnant with controversy." PROSSER AND KEETON, *supra* note 100, at 372.

[125]*Id.*

Although many courts refuse to allow any damages for the costs of raising the child,[126] a growing number of jurisdictions permit such a recovery but require it to be reduced by the accompanying benefits which may be expected to accrue to the parents in raising the child.[127] Typical of cases adopting this view is *Jones v. Malinowski*,[128] where the Maryland Supreme Court stated:

> By allowing the jury to consider the future costs, both pecuniary and non-pecuniary, of rearing and educating the child, we permit it to consider all the elements of damage on which the parents may present evidence. By permitting the jury to consider the reason for the procedure and to assess and offset the pecuniary and non-pecuniary benefits which will inure to the parents by reason of their relationship to the child, we allow the jury to discount those damages, thus reducing speculation and permitting the verdict to be based upon the facts as they actually exist in each of the unforeseeable variety of situations which may come before the court.[129]

Relying on this line of reasoning, it would not be untenable for a defendant in a wrongful adoption case similarly to assert that damages should be reduced by any benefits conferred on the adoptive parents.

Such an argument, however, overlooks the major premise upon which the benefit rule has been implemented in wrongful birth cases. The fundamental distinction is that any benefits conferred on the wrongful adoption victims would have likely accrued to them regardless of the tortfeasor's actions since they were interested in adopting a child. The victims of wrongful birth, on the other hand, would not have received a new family member but for the tortious conduct. The authors of the Restatement benefit rule of section 920 specifically addressed this problem in their official comments, writing, "Under the rule stated in this Section to justify a diminution of damages the benefit must result from the tortious conduct . . . . The rules of causation applicable to the creation and extent of liability . . . apply to the diminution of damages."[130]

More simply put, the prospective parents seeking to adopt would likely have adopted a child and enjoyed the benefits of a loving relationship

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[126]*Id.*; *see also* Wilbur v. Kerr, 275 Ark. 239, 628 S.W.2d 568 (1982); Schork v. Huber, 648 S.W.2d 861 (Ky. 1983).

[127]Prosser and Keeton, *supra* note 100, at 372; *see also* Ochs v. Borelli, 187 Conn. 253, 445 A.2d 883 (1982); Troppi v. Scarf, 31 Mich. App. 240, 187 N.W.2d 511 (1971).

[128]299 Md. 257, 473 A.2d 429 (1984).

[129]*Id.* at 264, 473 A.2d at 437 (quoting University of Arizona v. Superior Court, 136 Ariz. 579, 586, 667 P.2d 1294, 1301 (1983)).

[130]Restatement (Second) of Torts § 920 comment (d) (1980).

with or without the tortious conduct of the party placing the child.[131] Neither the "but-for" test of causation nor the "substantial factor" causation test would be met in such a case. In wrongful adoption cases, therefore, the amount of damages awarded to the adoptive parents should not be offset because any benefits which accrued were not caused by the defendant.[132]

VII. Wrongful Adoption as a Superior Cause of Action to Annulment

With the basic workings of the wrongful adoption theory outlined, the pros and cons of this new cause of action require evaluation. One of the main beneficiaries of this theory is the adoptive parents whose rights have heretofore received sparse attention.[133] While the best interests of the child must take precedence, "the protection of . . . the adopting parents should [also] be considered along with that of the child."[134] The wrongful adoption theory recognizes for the first time that "just as couples must weigh the risks of becoming natural parents, taking into consideration a host of factors, so too should adoptive parents be allowed to make their decision in an intelligent manner."[135] By allowing adoptive parents to seek compensatory damages in these situations, they are able to keep their family unit intact while receiving redress for their injuries. In this way their right to be free from being victimized by fraud is recognized without forcing them to end their relationship with the child they have come to know as their own.

The adopted child would also seem to benefit from the wrongful adoption remedy in most cases. In the drastic annulment setting, the child is suddenly uprooted once again to join the ranks of the parentless. While annulment may be appropriate in cases where the fraud is immediately discovered before significant bonds are formed, it is contrary to the "great

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[131]In some cases the evidence might show, for whatever reasons, that the adoptive parents would not have adopted another child. In such situations the plaintiffs might argue that public policy should not allow a set off because the tort of fraud involved in wrongful adoptions is much more culpable than the negligence present in wrongful birth actions. In this scenario, the law of the jurisdiction should be examined to determine how the courts have dealt with set off in wrongful birth cases.

[132]Thus, total damages should include all direct and consequential damages caused by the tortious conduct. Prosser and Keeton, *supra* note 100, at 766. In some states, attorneys' fees may be available by statute, and punitive damages may be appropriate if the conduct meets the state's requirements for such an award.

[133]*See supra* note 1.

[134]*In re* Adoption of Children by O, 141 N.J. Super. 586, 589, 359 A.2d 513, 514 (1976).

[135]Burr v. Board of County Comm'rs, 23 Ohio St. 3d 69, 78, 491 N.E.2d 1101, 1109 (1986).

policy concern in making adoptions conclusive and final."[136] In cases such as *Burr*, however, the child will remain a part of an established family.

The only conceivable disadvantage to the child is the possible adverse psychological effect that may result where the child learns that he or she was the subject of a lawsuit. This same concern has been raised in a few wrongful birth cases where the child might similarly learn of the litigation that focused upon him. In *Boone v. Mullendore*,[137] for instance, the Alabama Supreme Court stated:

> Another problem is the possible harm that can be caused to the unwanted child who will one day learn that he not only was not wanted by his or her parents, but was reared by funds supplied by another person. Some authors have referred to such a child as an 'emotional bastard' in a realistic, but harsh, attempt to describe the stigma that will attach to him once he learns the true circumstances of his upbringing.[138]

Only a few jurisdictions, however, have found this concern significant enough to deny recovery for rearing costs in wrongful birth cases.[139] No case, however, has disallowed recovery for the other damages claimed in the wrongful birth setting for this reason.[140] While this concern certainly merits attention in wrongful adoption, it should not become so large as to bar the action itself. The adopted child would seem to be better off with her adoptive parents, even where she learns of the action, than if she were to be uprooted from her only family; in fact, the knowledge that her parents chose to seek monetary damages rather than annulment may serve to cement her relationship to the family. Any potential harmful effects that might flow to the adoptee are better left for counsel to discuss with the adoptive parents, taking into consideration the unique circumstances of their case, prior to initiation of a wrongful adoption tort suit.[141]

An additional potential windfall of the wrongful adoption theory is that by requiring perpetrators of adoption fraud to answer in civil damages, the action will serve to deter others from such tortious conduct in the future. While the main purpose of compensatory damages is to redress

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[136] *In re* Welfare of Alle, 304 Minn. 254, 257, 230 N.W.2d 574, 577 (1975).

[137] 416 So. 2d 718 (Ala. 1982).

[138] *Id.* at 722.

[139] *See, e.g.*, *Boone*, 416 So. 2d 718; Wilbur v. Kerr, 275 Ark. 239, 628 S.W.2d 568 (1982).

[140] *See, e.g.*, *Boone*, 416 So. 2d 718; *Wilbur*, 275 Ark. 239, 628 S.W.2d 568.

[141] For instance, after the *Burr* case was concluded, attorney Kenneth Cardinal, who had been co-counsel for the Burrs, turned down another wrongful adoption case because, among other reasons, the adopted child, now a teen-ager, would have been fully cognizant of the litigation. Telephone interview with Kenneth Cardinal, Esq. (Feb. 6, 1987).

the victim's injuries, it cannot be denied that these damages have also served the secondary purpose of reducing future conduct that would warrant such damages. Because annulment does not afford this additional benefit, the wrongful adoption theory is even more appealing.

VIII. Mandatory Disclosure Laws—Legislative Proposals That Could Reduce Adoption Fraud

One factor that may contribute to adoption fraud is that in most states, the records of the adoptee's medical and family background are sealed after the adoption is perfected, and can be seen by the adoptive parents only by court order.[142] These sealed record statutes may give the individuals placing the child a false sense of security that their fraud will never be discovered.[143] The rationale behind keeping these records confidential has been succinctly expressed by New York's highest court:

> This confidentiality serves several purposes. It shields the adopted child from possibly disturbing facts surrounding his or her birth and parentage, it permits the adoptive parents to develop a close relationship with the child free from interference or distraction, and it provides the natural parents with an anonymity that they may consider vital.[144]

These concerns are certainly valid and continue to be a strong rationale for maintaining confidentiality in the adoption process. The sealed record statutes, however, have the inherent quality of allowing vital information about the prospective adoptee to be kept from the adoptive parents.

Recently, though, a few state legislatures have enacted statutes that provide the prospective parents with access to vital medical records without interfering with the natural parents' desires to remain anonymous.[145] For instance, New York's statute, which was adopted in 1983, provides that

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[142]*See supra* note 81 for a discussion of sealed records. It is, of course, difficult to pinpoint the actual motives behind adoption fraud, particularly when many states and the federal government have statutes that give financial assistance to "special needs" placements. *See, e.g.*, Va. Code Ann. §§ 63.1-238.1 to -238.4 (Supp. 1986); Note, *Federal Adoption Assistance for Children with Special Needs*, 19 Clearinghouse Rev. 586 (Oct. 1985).

[143]Kenneth Cardinal, counsel for plaintiffs in the *Burr* case, believes that fraud was committed in that case simply to avoid the expense and additional paperwork which would have been required had the child been placed through the special needs program. He feels that the social worker in that case definitely felt secure because of the sealed records statute. Telephone interview with Kenneth Cardinal, Esq. (Feb. 6, 1987).

[144]Linda F.M. v. Department of Health, 52 N.Y.2d 236, 237, 418 N.E.2d 1302, 1303 (1981).

[145]*See, e.g.*, Ill. Rev. Stat. ch. 40, para. 1522.4 (Supp. 1986) (requiring, among other things, that a detailed health history of the biological parents be given to the adoptive parents; no sanctions included in the statute for failure to disclose); Kan. Prob. Code Ann. § 59-2278a

> [n]otwithstanding any other provision of law to the contrary, to the extent they are available, the medical histories of a child legally freed for adoption and of his or her natural parents, with information identifying such natural parents eliminated, *shall be provided* by an authorized agency to such child's prospective adoptive parent and upon request to the adoptive parent when such child has been adopted . . . .[146]

This provision also specifically defines what records must be disclosed to the adoptive parents:

> Such medical histories shall include all available information setting forth conditions or diseases believed to be hereditary, any drugs or medication taken during pregnancy by the child's natural mother and any other information, including any psychological information . . . which may be a factor influencing the child's present or future health.[147]

This provision places an affirmative duty on the agency to disclose this vital information to prospective parents before the adoption is perfected without infringing upon confidentiality.[148]

Indiana's statute, which became effective in 1986, similarly provides for disclosure of this important information:

> Accompanying the petition . . . [which must be filed with the appropriate court to perfect the adoption] . . . shall be a medical report of the health status and medical history of the adoptee and the adoptee's birth parents, including neonatal, psychological, physiological, and medical care history on forms prescribed by the state registrar (*a copy of this report shall be sent to the person identified as the state registrar in IC 31-3-4 and to the adoptive parents*). This subsection does not authorize the release of medical information that would result in the identification of a person.[149]

(Vernon Supp. 1987) (requiring genetic, medical, and social history of child to be filed with the petition for adoption; no sanctions included for failure fully to disclose); ME. REV. STAT. ANN. tit. 19, § 533 (Supp. 1986) (requiring available medical or genetic information to be supplied to the adoptive parents; no sanctions for nondisclosure included); TEX. FAMILY CODE ANN. § 16.032 (Vernon 1986) (expansive health history report to be provided to adoptive parents; no adoption may be granted until such report has been so provided and filed in the record of the proceedings).

[146]N.Y. SOC. SERV. LAW § 373a (McKinney Supp. 1986) (emphasis added).

[147]*Id.*

[148]Although this statute has not yet been the subject of litigation, the New York Court of Appeals has noted in dicta that by enacting this statute, the "legislature provided that adoptive parents *must* be furnished a medical history of the natural parents . . . after identifying information [is] removed. . . ." *In re* Estate of Walker, 64 N.Y.2d 354, 357, 486 N.Y.S.2d 899, 903, 476 N.E.2d 298, 302 (1985) (emphasis added).

[149]IND. CODE § 31-3-1-2(b) (Supp. 1986) (emphasis added).

The last sentence of this provision is thus broader than the New York statute in that it could be read to allow entire documents concerning the natural parents' health to be withheld on the grounds that disclosure "would result in the identification of a person." New York's statute is more specific in that it calls for the medical histories to be disclosed "with information identifying such natural parents eliminated."[150] The Indiana legislature and other states considering such legislation should consider adopting the New York language to eliminate this potential defect.

Although Indiana's statute provides criminal sanctions for anyone who "[k]nowingly supplies false information to a medical history,"[151] neither Indiana's nor any other state's provisions contain sanctions for failure to disclose this vital information. Certainly in most cases it can be presumed that counsel for the adoptive parents would be aware of the disclosure requirements and would insist upon compliance. To ensure that this information is provided, however, the legislatures of Indiana, New York, and other states with disclosure laws, as well as those of other jurisdictions that consider such enactments in the future, should provide some type of sanction for failure to disclose this information.

Despite these minor shortcomings, the mandatory disclosure laws are beneficial to all parties involved in the adoption process. The natural parents' confidentiality is protected[152] while the adoptive parents, who are more fully aware of the risks involved, are "allowed to make their decision in an intelligent manner."[153] As this information will more readily allow them "to prepare for any special needs the child may develop,"[154] the child's best interests are served because the parents will be better able to accept any potential risks that become realities. Even those placing children for adoption would seem to benefit if full disclosure is made because they would then not have to fear future wrongful adoption suits against them.

Although such laws cannot prevent those bent on adoption fraud from future misrepresentation,[155] these measures at least remove the sense of security which the sealed record statutes have provided in the past. Such mandatory disclosure laws are likely to be effective in deterring at least a small portion of adoption fraud and should therefore be embraced by all state legislatures.

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[150]N.Y. Soc. Serv. Law § 373a (McKinney Supp. 1986).

[151]Ind. Code § 31-3-4-19(1) (Supp. 1986).

[152]For instance, Indiana's statute provides criminal sanctions for anyone who unlawfully discloses or seeks to disclose any confidential information. *Id.* § 31-3-4-19(2).

[153]Burr v. Board of County Comm'rs, 23 Ohio St. 3d 69, 78, 491 N.E.2d 1101, 1109 (1986).

[154]*Id.*

[155]This is true in part because the statutes have no teeth, but it can also be attributed to the very nature of the adoption process wherein the anxious prospective parents are extremely vulnerable.

IX. Conclusion

Although mandatory disclosure laws will help deter adoption fraud, it is unlikely that this abuse of the adoption process will disappear in the foreseeable future. Rather, current trends in today's society indicate that instances of fraud in the adoption process may well be on the rise. Wrongful adoption is a viable cause of action for adoptive parents who are victimized by such adoption fraud.

This remedy is superior to annulment because it recognizes the rights of the adoptive parents, protects and promotes the best interests of the adopted child, and serves to deter future instances of adoption fraud. Wrongful adoption actions should lie for active fraud as well as non-disclosure where the party placing the child is in a position to control the adoptive parents' access to material information. A practitioner faced with a case of fraud practiced upon adoptive parents should seriously consider this theory as a possible remedy.

John R. Maley

Prepayment Penalties and Due-on-Sale Clauses in Commercial Mortgages: What Next?*

I. Introduction

In 1981, new-home mortgage yields climbed as high as 16.38%, while the prime rate charged by banks stood at 20.50%.[1] At the same time, outstanding commercial mortgage debts totaled approximately 277.5 billion dollars.[2] By the close of 1986, new home mortgage yields dropped to 9.69%, while the prime rate plummeted to 7.50%.[3] This significant decline in interest rates marked a coterminous increase in commercial lending. The outstanding commercial mortgage debt at the close of 1986 was nearly 525 billion dollars.[4]

Two common provisions in mortgage documents in the commercial mortgage industry are due-on-sale clauses and prepayment penalties.[5] The due-on-sale clause is a contractual provision that permits a lender to declare the entire balance of a loan immediately due and payable if the mortgaged real estate is transferred without the lender's consent.[6] A prepayment penalty is a penalty imposed upon the borrower for his exercise of the privilege of paying a loan before the loan's scheduled date of maturity.[7] The use of these two clauses in tandem has generated much of the interest prompting the writing of this Note.

The lender's imposition of a prepayment penalty pursuant to the exercise of a valid due-on-sale clause in the commercial mortgage context can be seen as a bargained for commercial cost of doing business.[8] However, when present interest rates are higher than interest rates at the date of the loan's inception, the use of these two clauses together

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*The author of this Note assisted in the preparation of Appellee's brief in First Indiana Federal Savings Bank v. Maryland Development Co., Inc., 509 N.E.2d 253 (Ind. App. 1987). The case involves several of the issues addressed in this Note.

[1]Council of Economic Advisors, Economic Report of the President Together with the Annual Report of the Council of Economic Advisors 324 (1987).

[2]*Id.* at 328.

[3]*Id.* at 325.

[4]*Id.* at 328.

[5]*See* Comment, *Prepayment Penalties After Garn-St. Germain: A Minor Coup for Consumers*, 1985 Det. C. L. Rev. 835 [hereinafter *Prepayment Penalties*].

[6]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 145 (1982).

[7]G. Nelson & D. Whitman, Real Estate Finance Law § 6.1 (2d ed. 1985) [hereinafter Real Estate Finance].

[8]*See* Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971).

results in "double-dipping"[9] by the lender and inequitable circumstances can result.[10]

The issue faced by both state and federal courts and legislatures today is the propriety of allowing these clauses to be exercised in tandem in the commercial mortgage context. The United States Supreme Court's decision in *Fidelity Federal Savings & Loan Association v. de la Custa*[11] providing for the enforceability of due-on-sale clauses in mortgages held by federal lending associations,[12] along with Congress' passage of section 341 of the Garn-St. Germain Depository Institutions Act[13] (Act), extending the ability to enforce due-on-sale clauses to both state and federal lenders,[14] have greatly settled questions concerning the validity and enforceability of due-on-sale clauses.

The enforceability of prepayment penalties by commercial lenders is not quite so settled. Presently there are no real "rules" concerning a commercial lender's ability to exercise a prepayment penalty provision.[15] However, under the power of the Home Owners' Loan Act[16] (HOLA), the Federal Home Loan Bank Board[17] (Board) has passed regulations

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[9]"Double-dipping" occurs when the lender exercises a due-on-sale clause, receiving the entire balance of the loan debt immediately, while also collecting a prepayment penalty because of the borrower's early payment of the loan.

[10]*See* George H. Hutman, Inc. v. Aetna Business Credit, Inc., 115 Misc. 2d 168, 453 N.Y.S.2d 586 (1982). The inequity of "double-dipping" results from the lender's ability to reinvest loan proceeds collected by the exercise of a due-on-sale clause at presently higher rates of interest, while also collecting a prepayment penalty from the borrower.

[11]458 U.S. 141 (1982).

[12]"Federal association" is defined as "[a] savings and loan association or savings bank chartered by the Board under section 5 of the [Garn-St. Germain Depository Institutions] Act and, except as the Board may otherwise provide, any building and loan, savings and loan, building or homestead association, organized or incorporated under the laws of the District of Columbia." 12 C.F.R. § 541.8 (1986).

[13]Pub. L. No. 97-320, Title III, § 341, 96 Stat. 1505 (1982) (codified as amended at 12 U.S.C. § 1701j-3 (1982 & Supp. 1985)).

[14]Under the Act, a "lender" is defined as "a person or government agency making a real property loan or any assignee or transferee, in whole or in part, of such a person or agency." 12 U.S.C. § 1701j-3(a)(2) (1982).

[15]*See infra* notes 170–210 and accompanying text.

[16]Home Owners' Loan Act, 12 U.S.C. §§ 1461-1470 (1982 & Supp. 1985).

[17]The Federal Home Loan Bank Board is an independent federal regulatory agency founded in 1932 and is vested with authority to administer HOLA. 12 U.S.C. §§ 1421-1449 (1982 & Supp. 1985). The role of the Board is stated explicitly in HOLA:

> In order to provide thrift institutions for the deposit or investment of funds and for the extension of credit for homes and other goods and services, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as Federal savings and loan associations, or Federal savings banks, and to issue charters therefor, giving primary consideration to the best practices of thrift institutions in the United States. The lending and investment authorities are conferred by this section to provide such

limiting a lender's right to collect a prepayment penalty in residential mortgages under certain circumstances, including the lender's election to accelerate the balance of the mortgage debt pursuant to the exercise of a due-on-sale clause.[18]

Some states have also imposed limitations upon a lender's ability to collect a prepayment penalty;[19] however, the effect of these state law limitations upon federal lenders is unclear. The Board has passed regulations purportedly preempting all state law addressing "the subject of the operations of a Federal association."[20] However, the Court in *de la Cuesta* refused to decide whether the preemption of contradictory state law governing the validity and enforceability of due-on-sale clauses also included preemption of state law regarding the enforcement of prepayment penalties.[21] Even if the Board's regulations do preempt state laws restricting a federally-chartered lender's ability to enforce a prepayment penalty, it is unclear whether a federally-chartered lender may enforce a prepayment penalty upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause.[22]

This Note will analyze, by analogy to residential loan rules, the propriety of commercial "double-dipping." It will propose that action by Congress, the Board, or both is warranted to clear the confusion surrounding the collection of prepayment penalties in the commercial mortgage context. Finally this Note will show that while commercial lenders may easily protect themselves under present law, policy considerations compel the conclusion that commercial borrowers should be afforded the same protections as residential borrowers through statutory and/or regulatory action by Congress or the Board.

II. Due-on-Sale Clauses

A. Background

In order to understand fully the result of allowing lenders to utilize both acceleration and prepayment penalty clauses, it is necessary to examine the judicial treatment of such clauses in the residential context. As mentioned, the due-on-sale clause[23] is a contractual provision that

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institutions the flexibility necessary to maintain their role of providing credit for housing.

12 U.S.C. § 1464(a) (1982).

[18]12 C.F.R. § 591.5(b)(2), (3) (1986). *See also infra* notes 162-64 and accompanying text.

[19]*See infra* notes 145-61 and accompanying text.

[20]12 C.F.R. § 545.2 (1986).

[21]458 U.S. at 159 n.14. *See also infra* notes 174-75 and accompanying text.

[22]*See infra* notes 203-10 and accompanying text.

[23]A commonly used due-on-sale clause is found in ¶ 17 of the uniform mortgage

permits a lender to declare the entire balance of a loan immediately due and payable if the mortgaged real estate is transferred without the lender's consent.[24] The major purpose of the clause is to enable lenders to recall lower than market interest rate loans during periods of rising interest rates,[25] although the clause has been used to protect lenders against transfers that threaten mortgage security or increase the risk of default.[26]

Prior to 1930, due-on-sale clauses were not common in mortgages or deeds of trust,[27] although clauses of a similar nature were often

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instrument developed by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. This clause provides:

> 17. Transfer of the Property; Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to this Deed of Trust, (b) the creation of a purchase money security interest for household appliances, (c) a transfer by devise, descent or by operation of law upon the death of a joint tenant, or (d) the grant of a leasehold interest of three years or less not containing an option to purchase, *Lender may, at Lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable.* Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the Property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender and that the interest payable on the sums secured by this Deed of Trust shall be at such rate as Lender shall request. If Lender has waived the option to accelerate provided in this paragraph 17 and if Borrower's successor in interest has executed a written assumption agreement accepted in writing by Lender, Lender shall release Borrower from all obligations under this Deed of Trust and the Note.
>
> If Lender exercises such option to accelerate, Lender shall mail Borrower notice of acceleration in accordance with paragraph 14 hereof. Such notice shall provide a period of not less than 30 days from the date the notice is mailed within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the execution of such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 18 hereof.

Fidelity Fed. Sav. & Loan Ass'n. v. de la Cuesta, 458 U.S. at 145-46 n.2 (Emphasis supplied).

This clause has been criticized as incomprehensible to all but trained lawyers. Many residential borrowers may be unaware of its import. *See* Squires, *A Comprehensible Due on Sale Clause*, 27 Prac. Law. 67 (1981). One court has implied that this clause may be inadequate to permit due on sale clause enforcement in the installment land sale contract situation. *See* Boyes v. Valley Bank of Nevada, 101 Nev. 287, 292 n.4, 701 P.2d 1008, 1012 n.4 (1985).

[24]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. at 145.

[25]Volkmer, *The Application of Restraints on Alienation Doctrine to Real Property Security Interest*, 58 Iowa L. Rev. 747, 769 (1973).

[26]*See* Real Estate Finance, *supra* note 7, § 5.21.

[27]A deed of trust is a device normally involving a conveyance of realty to a third person in trust to hold as security for the payment of a debt to a lender. Deeds of trust often contain a power of sale in the trustee and are thus similar to mortgages with a power of sale. *See id.*

included in land sales contracts.[28] In recent years, the clause has been the subject of a great deal of scholarly commentary[29] and has become a great source of controversy as a result of the inflationary economic climate of the 1970's and early 1980's.[30] The adverse economic conditions, including periods of rising interest rates, have tended to pit lenders against borrowers and real estate buyers thereby intensifying the economic, political, and legal aspects of the issues.[31]

Traditionally, due-on-sale clauses have been attacked as unreasonable restraints upon alienation.[32] These attacks have taken different approaches. Under one approach, the clause is deemed reasonable per se absent a showing of duress, fraud, or unconscionable or inequitable conduct on the part of the lender.[33] The lender need not establish that a proposed sale would endanger security under this approach.[34] Another approach maintains that enforcement of due-on-sale clauses must be reasonable under the circumstances, necessitating a case by case deter-

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[28]Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F.L. Rev. 267, 271 (1972).

[29]*See generally* Ashley, *Use of "Due-On" Clauses to Gain Collateral Benefits: A Common Sense Defense*, 10 Tulsa L.J. 590 (1975); Gorinson & Manishin, *Garn-St. Germain: A Harbinger of Change*, 40 Wash. & Lee L. Rev. 1313 (1983); Maxwell, *The Due-on-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 UCLA L. Rev. 197 (1980); Nelson & Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act*, 35 Hast. L.J. 241 (1983); Segreti, *The Borrower as Servant to the Lender: Enforcement of Mortgage Due-on-Sale Clauses*, 51 U. Cin. L. Rev. 779 (1982).

[30]The economic climate of the 1970's and early 1980's was characterized by double-digit inflation, rising prices and wages, dollar devaluation, long term unfavorable balances of trade, high unemployment, and large federal budget deficits. *See* Comment, *An Update of the Law Governing Prepayment Clauses*, 17 San Diego L. Rev. 1047 (1980) [hereinafter *Update*].

[31]*See* Real Estate Finance, *supra* note 7, § 5.21.

[32]Restatement of Property § 404 (1944) defines restraints on alienation as

> an attempt by an otherwise effective conveyance or contract to cause a later conveyance (a) to be void [disabling restraint]; or (b) to impose contractual liability on the one who makes the later conveyance when such liability results from a breach of an agreement not to convey [promissory restraint]; or (c) to terminate or subject to termination all or a part of the property interest conveyed [forfeiture restraint].

[33]*See* Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975) (exercise of due-on-sale clause reasonable and not an invalid restraint on alienation absent proof the lender acted fraudulently, inequitably, or unconscionably). *Accord* Martin v. Peoples Mut. Sav. & Loan Ass'n, 319 N.W.2d 220 (Iowa 1982); Dunham v. Ware Sav. Bank, 394 Mass. 63, 423 N.E.2d 998 (1981); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976); Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 633 S.W.2d 811 (Tex. 1982).

[34]Baker v. Loves Park, 61 Ill. 2d at 124, 333 N.E.2d at 5.

mination.[35] The burden of establishing reasonableness is imposed upon the lender under this approach, and he usually must show that the sale or transfer would result in a threat to security or an increased danger of default.[36]

In several cases where courts upheld a due-on-sale clause, the absence of a prepayment penalty was held to be dispositive. Thus, in *Century Federal Savings & Loan Association v. Van Glahn*,[37] the court enforced a contractual acceleration clause where the borrower enjoyed a statutory privilege of prepayment with only a slight penalty.[38] The court reasoned that the only way to give the lender the benefit of the bargain was to allow acceleration of the loan upon transfer.[39] The North Carolina Supreme Court, in *Crockett v. First Federal Savings & Loan Association*,[40] employed similar reasoning when it found "noteworthy [the fact that] . . . under the loan agreement entered into in this case, [the borrower] could prepay at any time without penalty."[41] The court concluded that "in order to balance the ability of lender and borrower to take advantage of fluctuations in interest rates, equities favor the limited adjustment permissible by the due-on-sale clause."[42] In *Dunham v. Ware Savings Bank*,[43] the Supreme Judicial Court of Massachusetts recognized that the borrower's ability to benefit through early payment of the loan during periods of falling interest rates was not equal in value to the lender's ability to benefit through acceleration of the loan during periods of rising interest rates.[44] However, the court held that equity favored enforcing the lender's rights where a Massachusetts statute permitted the borrower to prepay with little or no penalty.[45] A different analysis was used in *Baltimore Life Insurance Co. v. Harn*,[46] where an Arizona

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[35]*See* Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P.2d 190 (1971) (exercise of due-on-sale clause reasonable since it did not "absolutely" restrict the mortgagors' ability to dispose of their property); Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (enforcement of due-on-sale clause improper absent lender's showing that "enforcement is reasonably necessary to protect against impairment to its security or the risk of default"); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977) (due-on-sale clause not enforced absent lender's showing that the clause was reasonable in the particular case).

[36]Wellenkamp v. Bank of Am., 21 Cal. 3d at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

[37]144 N.J. Super. 48, 364 A.2d 558 (1976).

[38]*Id.* at 51, 364 A.2d at 562.

[39]*Id.*

[40]289 N.C. 620, 224 S.E.2d 580 (1976).

[41]*Id.* at 625, 224 S.E.2d at 585.

[42]*Id.*

[43]384 Mass. 63, 423 N.E.2d 998 (1981).

[44]*Id.* at 69, 423 N.E.2d at 1002.

[45]*Id.*

[46]15 Ariz. App. 78, 486 P.2d 190 (1971).

appellate court observed that when a lender invokes an acceleration clause along with a prepayment penalty, the result could be unconscionably harsh.[47] In concluding, the court noted that "[c]ourts of equity may refuse to enforce these clauses where they will work a hardship on the [borrower] and the [lender] is not prejudiced by the breach."[48]

In 1976, the Board became concerned about the increasing controversy as to a federal savings and loan association's authority to exercise a due-on-sale clause included in a residential mortgage contract.[49] The Board listed several adverse effects that could result from restrictions upon a savings and loan's ability to accelerate upon transfer of the security: (1) "the financial security and stability of Federal associations would be endangered if . . . the security property is transferred to a person whose ability to repay the loan and properly maintain the property is inadequate," (2) "elimination of the due-on-sale clause will cause a substantial reduction of the cash flow and net income of Federal associations, and . . . to offset such losses it is likely that the associations will be forced to charge higher interest rates and loan charges on home loans generally," and (3) "elimination of the due-on-sale clause will restrict and impair the ability of Federal associations to sell their home loans in the secondary mortgage market, by making such loans unsalable or causing them to be sold at reduced prices, thereby reducing the flow of new funds for residential loans which otherwise would be available."[50] The Board concluded that elimination of the due-on-sale clause would benefit only a limited number of home sellers, while generally causing economic hardship to the majority of home buyers and potential home buyers.[51]

In order to resolve the controversy surrounding a federal savings and loan association's authority to exercise a due-on-sale clause included in a residential mortgage contract, the Board issued a regulation in 1976 authorizing due-on-sale clauses in real estate loan instruments.[52] In the

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[47]*Id.* at 81, 486 P.2d at 193.

[48]*Id.*

[49]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 145 (1982).

[50]*Id.* at 145-46 (citing 41 Fed. Reg. 6283, 6285 (1976)).

The secondary mortgage market is that market where lenders who have originated loans sell or assign the loans to investors or government sponsored agencies which will hold the loans for the long term. *See* Real Estate Finance, *supra* note 7, § 11.1. Among the government agencies participating in the secondary mortgage market are the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Government National Mortgage Association (GNMA). *Id.* § 11.3.

[51]*de la Cuesta*, 458 U.S. at 146.

[52]12 C.F.R. § 545.8-3(f) (1983) (originally codified at 12 C.F.R. § 545.6-11(f) (1976)) provides that a federal savings and loan association

> continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instrument whereby the association may,

preamble to this regulation, the Board expressed its intent that the due-on-sale practices of federal savings and loans be governed solely by federal law, thus preempting any state laws imposing different requirements.[53] This interpretation did not receive unanimous acceptance, and the following six years were marked by an extraordinary volume of litigation challenging the preemption of state due-on-sale clause law.[54] While the federal courts tended to conclude that the Board regulation preempted state due-on-sale clause law,[55] several state courts reached contrary results.[56]

Those state courts finding no congressional intent for the Board to pass due-on-sale clause regulations preempting contradictory state law often pointed to the lack of express language in HOLA regarding the Board's power to pass such preemptory regulations. For example, the court in *Holiday Acres v. Midwest Federal Savings & Loan Association*[57] relied heavily upon the argument that mortgage law was traditionally the domain of the states as a reason for not inferring congressional intent to preempt state due-on-sale clause law.[58] That court also interpreted narrowly the authority granted to the Board under section 5(a) of HOLA, holding that HOLA was merely intended as an expedient cure for the Depression.[59] Interestingly, the court did not take notice of the preamble to the Board's due-on-sale clause regulation, which manifested an unequivocal intent to preempt conflicting state law.[60] Another case reaching a similar conclusion was *First Federal Savings &*

> at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent . . . . Exercise . . . of such option . . . shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract.

This regulation was amended subsequent to the passage of the Act, and now includes both federal lenders and non-federal lenders. *See* 12 C.F.R. § 591.3, § 591.4 (1986).

[53]41 Fed. Reg. 18,287 (1976).

[54]*See generally Prepayment Penalties*, *supra* note 5.

[55]*See e.g.*, Baily v. First Fed. Sav. & Loan Ass'n, 467 F. Supp. 1139 (C.D. Ill. 1979); Glendale Fed. Sav. & Loan Ass'n v. Fox, 459 F. Supp. 903 (C.D. Cal. 1978).

[56]*See e.g.*, Panko v. Pan Am. Fed. Sav. & Loan Ass'n, 119 Cal. App. 3d 916, 174 Cal. Rptr. 240 (1981), *vacated*, 458 U.S. 1117 (1982); First Fed. Sav. & Loan Ass'n of Englewood v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981).

[57]308 N.W.2d 471 (Minn. 1981).

[58]*Id.* at 477-79.

[59]*Id.* at 479.

[60]The preamble provides in relevant part: "It was and is the Board's intent to have . . . due-on-sale practices of Federal associations governed exclusively by Federal law . . . Federal associations shall not be bound by or subject to any conflicting State law which imposes different . . . due-on-sale requirements." 41 Fed. Reg. 18,286 (1976).

Loan Association of Englewood v. Lockwood,[61] where the court concluded that equity rather than the Board regulation was the overriding factor in determining the enforceability of due-on-sale clauses.[62]

B. Resolution of the Due-On-Sale Controversy

The controversy concerning the Board's authority to preempt state law that prohibited or restricted the enforcement of due-on-sale clauses by federal associations was finally resolved by the Supreme Court in *de la Cuesta*.[63] The Court upheld the Board's 1976 regulation against a preemptive state law challenge, concluding that the Board intended to preempt state law.[64] Interpreting the 1976 regulation, the Court held that the regulation in fact conflicted with state law, despite the fact that it merely authorized, without requiring, the use of due-on-sale clauses by federal associations.[65] The Court also held that the Board acted within its statutory authority under section 5(a) of HOLA, concluding that HOLA clearly empowered the Board to promulgate rules for the operation and regulation of federal associations,[66] including the use of due-on-sale clauses in loan contracts.[67] The majority observed that the wisdom of the Board's regulation was not uncontroverted, but concluded that the Board's exercise of authority was reasonable and therefore valid.[68]

While *de la Cuesta* validated the enforcement of due-on-sale clauses by federal savings and loan associations, that decision did not apply to lenders not covered by the Board's regulation. In order to extend the *de la Cuesta* protection to all lenders, Congress passed the Garn-St. Germain Depository Institutions Act.[69] This Act has been described as "signal[ing] the dawn of a new era for due-on-sale clause enforcement."[70]

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[61] 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

[62] *Id.* at 160.

[63] 458 U.S. 141 (1982). Justice Blackmun delivered the opinion of the Court, joined by Chief Justice Burger and Justices Brennan, White, Marshall, and O'Connor. Justice O'Connor filed a concurring opinion. Justice Rehnquist dissented, joined by Justice Stevens. Justice Powell took no part in the consideration or decision of the case. *Id.*

[64] *Id.* at 158-59. The Court noted the Board's intent that "[f]ederal associations . . . not be bound by or subject to any conflicting State law which imposes different . . . due-on-sale requirements." *Id.* at 158.

[65] *Id.* at 154-55.

[66] *Id.* at 159-61.

[67] *Id.* at 167.

[68] *Id.* at 169-70.

[69] Pub. L. No. 97-320, Title III, § 341, 96 Stat. 1505, (1982) (codified as amended at 12 U.S.C. § 1701j-3 (1982 & Supp. 1985)).

[70] *See* Real Estate Finance, *supra* note 7, § 5.24. President Reagan hailed the Act as "the most important legislation for financial institutions in the last fifty years." *Garn-St. Germain Financial Reform Bill Signed by President Reagan*, Wash. Fin. Rep. (BNA) No. 39, at 743 (Oct. 25, 1982).

The Act affirmed the federal preemption of state law restrictions upon due-on-sale clause enforcement and extended that preemption to all lenders holding commercial or residential real property loans.[71] The legislative history of the Act reveals Congress' recognition that the practice of borrowing short and lending long,[72] at fixed rates, combined with high and volatile interest rates resulted in the financial depression experienced by many lenders.[73] The Act was primarily intended by Congress to be of aid to those economically troubled institutions.[74]

The Act covers any "person or government agency making a real property loan."[75] The Board has emphasized that the list of lenders included within this definition is "intended to be representative and not exclusive."[76] The Act also covers every "loan, mortgage, advance, or credit sale secured by a lien on real property, the stock allocated to a dwelling unit in a cooperative housing corporation, or a residential manufactured home, whether real or personal property."[77]

Congress limited the broad reach of the Act in several important respects. Responding to effective lobbying by the real estate brokerage industry and related interests,[78] Congress softened the impact of the Act in many states by creating exceptions to the preemption on loans assumed

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[71]50 Fed. Reg. 46,746 (1985).

[72]The practice of borrowing short and lending long occurs when lenders lend large sums of money at fixed rates of interest for long periods of time while market interest rates continue to rise. This practice leads to a scenario where the cost of funds for lenders rises faster than the yield on their assets, rendering lenders unable to cover their operating expenses. *See* S. Rep. No. 536, 97th Cong., 2d Sess. (1982), *reprinted in* 1982 U.S. Code Cong. & Admin. News 3059.

[73]*Id.* Congress observed that "the cost of funds has increased rapidly, while slow repayment of old mortgages had led to an extremely sluggish increase in the gross asset yields." *Id.*

[74]*Id.*

[75]12 U.S.C. § 1701j-3(a)(2) (Supp. 1985). Under the present regulation, this definition includes

> without limitation, individuals, Federal associations, state-chartered savings and loan associations, national banks, state-chartered banks and state-chartered mutual savings banks, Federal credit unions, state-chartered credit unions, mortgage banks, insurance companies and finance companies which make real property loans, manufactured home retailers who extend credit, agencies of the Federal government, [and] any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act.

12 C.F.R. § 591.2(g) (1986).

[76]48 Fed. Reg. 21,555 (1983).

[77]12 U.S.C. § 1701j-3(a)(3) (Supp. 1985).

[78]*See generally Mortgage Assumption Plan Approved*, 40 Cong. Q. 2126 (1982); *Savings and Loan Aid Package Boosts Powers of Banks, Thrifts*, 40 Cong. Q. 2423 (1982); *Senate Passes Comprehensive Financial Institutions Bill*, Hous. & Dev. Rep. (BNA) No. 10, at 356 (Sept. 27, 1982).

or originated during a "window period."[79] Congress also expressly enumerated several types of transfers that could not be used as the basis for due-on-sale acceleration.[80] However, these insulated transfers were immune from acceleration only if the mortgaged real estate contained "less than five dwelling units."[81] Congress cited the policy basis behind the exclusions as the protection of consumers "by prohibiting the enforcement of due-on-sale clauses where such enforcement would be inequitable."[82]

The Supreme Court's decision in *de la Cuesta* validating federal preemption of state laws concerning a federal savings and loan association's ability to include and enforce due-on-sale clauses, along with

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[79]Congress exempted certain loans ("window period loans") from coverage under the Act until three years from its effective date (October 15, 1985) based upon a recognition that complete federal preemption of state laws seeking to limit due-on-sale clauses could have an unfair impact upon home buyers attempting to assume existing mortgages in reliance upon state law. *See* S. Rep. No. 536, 97th Cong., 2d Sess. (1982), *reprinted in* 1982 U.S. Code Cong. & Admin. News 3076. The concept of "window period loans" is complex and is not clearly defined in the Act or subject to easy explanation. "Window period loans" exist only in states that prohibited the exercise of due-on-sale clauses prior to the passage of the Act. 12 U.S.C. § 1701j-3(c)(1) (Supp. 1985). Under the "window period" concept, state law applicable to due-on-sale clauses is not preempted until three years after the Act's enactment. *Id.* The "window period" may vary from state to state or be nonexistent in a state, depending on the state's treatment of due-on-sale clauses prior to the passage of the Act. *Id.*

The Board declined to identify the states qualifying for "window period" treatment, although requested to do so, on the grounds that Congress intended "window period" determinations to be left to "state interpretation and state judicial decision." 48 Fed. Reg. 21,555 (1983). Only states that previously "prohibited the exercise of due-on-sale clauses" qualify for "window period" treatment. 12 U.S.C. § 1701j-3(c)(1) (Supp. 1985).

[80]This list includes: (1) the creation of a lien or other encumbrance subordinate to the lender's security instrument that does not relate to a transfer of rights of occupancy in the property; (2) the creation of a purchase money security interest for household appliances; (3) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety; (4) the granting of a leasehold interest of three years or less not containing an option to purchase; (5) a transfer to a relative resulting from the death of a borrower; (6) a transfer where the spouse or children of the borrower become an owner of the property; (7) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property; (8) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and occupant of the property. 12 C.F.R. § 591.5(b)(1) (1986).

[81]Pub. L. No. 98-181, tit. IV, § 473, 473 Stat. 1237 (1983) (codified at 12 U.S.C. § 1701j-3(d) (1982 & Supp. 1985)). This language, absent from the original Act, was added on November 30, 1983, in response to concerns that the insulated transfers would prevent due-on-sale clause enforcement in a variety of commercial and non-residential settings. *See* Real Estate Finance, *supra* note 7, § 5.24. The Board sought to alleviate fears by limiting application of the insulated transfers to mortgage loans made "on the security of a home occupied . . . by the borrower." 12 C.F.R. § 591.5(b) (1986).

[82]S. Rep. No. 536, 97th Cong. 2d Sess. (1982), *reprinted in* 1982 U.S. Code Cong. & Admin. News 3079.

Congress' passage of the Act, have largely settled questions concerning the validity and enforceability of due-on-sale clauses.[83] Yet to be resolved by action of the Supreme Court or Congress is whether a commercial lender may collect a prepayment penalty pursuant to the exercise of a valid due-on-sale clause. Resolution of this issue must commence with an examination of prepayment penalties.

III. Prepayment Penalties

A. Background

1. Justification for Prepayment Penalties.—Since at least 1845, courts have recognized that there is no common law right to discharge a mortgage debt prior to its maturity.[84] Under the common law, the ability to prepay depended upon a specific provision in the mortgage or note providing for prepayment.[85] As a result, the lender has the right to refuse an early tender of principal and interest and will not be judicially compelled to discharge the mortgage prematurely.[86] The common law

[83]Excepting the so-called "window period loans" 12 U.S.C. § 1701j-3(c)(1) (Supp. 1985), and excepting certain state courts that have refused to apply the Act to transactions occurring before the date of the Act's enactment. *See* North Community Bank v. Northwest Nat'l Bank, 126 Ill. App. 3d 581, 467 N.E.2d 1094 (1984); Central Nat'l Bank of Greencastle v. Shoup, 501 N.E.2d 1090 (Ind. Ct. App. 1986); Viereck v. Peoples Sav. & Loan Ass'n, 343 N.W.2d 30 (Minn. 1984); Stinger v. Great S. Sav. & Loan Ass'n, 677 S.W.2d 376 (Mo. Ct. App. 1984); Boyes v. Valley Bank of Nevada, 101 Nev. 287, 701 P.2d 1008 (1985); Home Sav. Bank v. Baer Properties, Ltd., 92 A.D.2d 98, 460 N.Y.S.2d 833 (1983); Morris v. Woodside, 101 Wash. 2d 812, 682 P.2d 905 (1984). These courts reason that because they are not subject to the Act's "window periods," and because the Act expresses no clear manifestation of retroactivity, the Act does not apply to transactions occurring before the effective date of the Act.

[84]This rule derives from the early case of Brown v. Cole, 60 Eng. Rep. 424 (1845), where the court surmised that if borrowers were allowed to pay off their mortgage money at any time after the execution of the mortgage, it might be attended with extreme inconvenience to lenders, who generally advance their money as an investment.

[85]Real Estate Finance, *supra* note 7, § 6.1.

[86]*See* Smiddy v. Grafton, 163 Cal. 16, 124 P. 433 (1912); Peter Fuller Enter., Inc. v. Manchester Sav. Bank, 102 N.H. 117, 152 A.2d 179 (1959). This rule was applied in an inequitable fashion by the Fifth Circuit in Houston N. Hosp. Properties v. Telco Leasing, Inc., 680 F.2d 19 (5th Cir. 1982). In that case, the borrower offered to pay the outstanding balances on two loans held by the lender. The lender refused the offer, informing the borrower that it would accept full payment of the loans (approximately $797,000) only if the borrower agreed to pay an additional $160,000. *Id.* at 20-21. Rejecting the borrower's appeal of a summary judgment granted to the lender upon the borrower's suit to recover the $160,000, the court recognized the lender's right to reject prepayment in the absence of a contractual right of prepayment by the borrower in the loan documents. *Id.* at 22. The court concluded: "Having a good investment that did not require acceptance of prepayment, [the lender] could use market tactics to exact a profit. Our entrepreneurial economic system does not exact moral scruples in deals between parties of equal bargaining power." *Id.* at 22-23.

rule has been rejected in a variety of modern day contexts.[87] Currently, most lenders permit prepayment, but often exact a "prepayment penalty."[88] The modern practice has often been to include the borrower's right to prepay as an express condition in the loan agreement.[89]

Although numerous theories have been commonly advanced in support of prepayment penalties, three primary theories are cited most often.[90] The first of these has been labeled the "recapture rationale."[91] Lenders argue that the costs to them of making loans are not recouped at the time the loan is made. Rather, the costs are amortized over the entire length of the loan period and would be lost absent a penalty for early payment.[92] This theory has been criticized by the Board and numerous commentators who argue that closing costs and other charges collected by lenders at the inception of the loan more than compensate for such fixed costs.[93]

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[87]In Pennsylvania, the presumption is that a loan may be prepaid unless the mortgage documents refute the presumption. Mahoney v. Furches, 503 Pa. 60, 468 A.2d 458 (1983).

[88]*See* Real Estate Finance, *supra* note 7, § 6.1. The phrase "prepayment penalty" has been labeled "prepayment privilege" by lenders and others who favor the imposition of a charge by the lender in the event of prepayment by the borrower. *See* Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971). By contrast, opponents of the charge characterize it as a "prepayment penalty." *See* American Fed. Sav. & Loan Ass'n of Madision v. Mid-America Serv. Corp., 329 N.W.2d 124 (S.D. 1983); Comment, *Secured Real Estate Loan Prepayments and the Prepayment Penalty*, 51 Calif. L. Rev. 923 (1963) [hereinafter *Secured Real Estate Loan Prepayments*]. Others have utilized more neutral expressions such as "prepayment premium" or "prepayment fees." *See In re* L.H.D. Realty Corp., 726 F.2d 327 (7th Cir. 1984); 1 *H. Miller & M. Starr, Current Law of California Real Estate* 444 (1965).

[89]The modern practice of expressly providing for the borrower's right to prepay in the loan agreement is referred to as the "option" situation. *See Update*, *supra* note 30, at 1049. A different situation occurs where the loan agreement omits any mention of prepayment. When the borrower desires to prepay, he must negotiate with the lender and is in the undesirable position of having the lender determine the amount of the penalty. *See* Houston N. Hosp. Properties v. Telco Leasing, Inc., 680 F.2d 19 (5th Cir. 1982), where the court upheld the lender's determination of the charge for the borrower's right to prepay. This situation is referred to as the "non-option" type and may result in the lender being unable to collect a penalty because some states prohibit collection of a penalty unless specifically provided for in the loan documents. *See* Burks v. Verschuur, 35 Colo. App. 121, 532 P.2d 757 (1975); *Update*, *supra* note 30, at 1049.

[90]Another theory for upholding prepayment penalties is that they serve the purposes of both the lender and the borrower. For example, the borrower is enabled to save interest or to have his property released from the lien early, while the lender is able to protect his investment income. *See generally* Annotation, *Construction and Effect as to Interest Due of Real Estate Mortgage Clause Authorizing Mortagor to Prepay Principal Debt*, 86 A.L.R. 3d 599, 604 (1978).

[91]*See Prepayment Penalties*, *supra* note 5, at 847.

[92]*See Bonanno*, *supra* note 28, at 295.

[93]Criticizing the theory, the Board has commented that "this rationale seems debatable because the closing costs and other charges collected by the lender upon origination may

A second theory advanced by lenders in support of prepayment penalties is the "income" argument.[94] Lenders argue that prepayment penalties constitute a substantial portion of their annual income, the loss of which would not only endanger existing loans but would restrict the availability of loans to future borrowers.[95]

The third justification commonly advanced in support of prepayment penalties is the "economic complement" argument.[96] According to this theory, the due-on-sale clause enables lenders to avoid being locked into loans at rates below current market levels. The lender is able to refuse assumptions and, by accelerating the unpaid balance of the loan, is able to reinvest its funds at higher market interest rates.[97] The prepayment penalty clause is employed by lenders to "lock in" loans at interest rates higher than current market rates by discouraging refinancing by borrowers when market interest rates drop below those of the borrower's loan.[98]

The use of prepayment penalty and acceleration clauses in tandem has been described as "another imperfect method for achieving a higher long term return on the [lender's] loan portfolio"[99] and as a method to reduce the risk associated with fixed rate lending.[100] The Board has noted that "[p]roperly used, [prepayment and acceleration clauses] can

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more than compensate it for its fixed costs." 49 Fed. Reg. 32,081 (1984). One commentator argued

> that lenders also charge 'points' (which is actually a form of discounting the borrower's rate), for making a new loan or for accepting an assumption of an outstanding loan. In addition, they require payments for such present and future expenses as credit reports, ALTA title insurance, and even reconveyance fees. Consequently, the traditional justification hardly seems credible any more.

Bonanno, *supra* note 28, at 295.

[94]*Prepayment Penalties*, *supra* note 5, at 848.

[95]One commentator has noted that lenders argue that prepayment penalties comprise anywhere from twelve to thirty-eight percent of their annual net incomes. *See id.* at 848-49.

[96]*See* Real Estate Finance, *supra* note 7, § 6.1; *Prepayment Penalties*, *supra* note 5, at 849.

[97]*See Prepayment Penalties*, *supra* note 5, at 849. The alternative use of the due-on-sale and prepayment penalty clauses by lenders is distinguishable from the variable interest rate situation. When variable interest rates are used, interest rates on long term mortgages rise or fall in conjunction with some index that is related or tied to market interest rates. When the lender employs the due-on-sale and prepayment penalty clauses together, the prepayment penalty is used to keep the lender's portfolio interest return from dropping while the due-on-sale clause is applied to reloan money at higher market rates. Thus, the lender is able to protect itself from the adverse economic effects of dropping interest rates, an impossible result with variable interest rates. *See* Real Estate Finance, *supra* note 7, § 6.1.

[98]*See* Real Estate Finance, *supra* note 7, § 6.1.

[99]*Id.*

[100]*See Prepayment Penalties*, *supra* note 5, at 830.

help lenders in preserving both original contract terms and anticipated yields as a means of matching the durations of their assets and liabilities."[101]

2. Attacks on Prepayment Penalties.—Borrowers have unsuccessfully attacked prepayment penalties upon numerous grounds. For example, it has been asserted that a prepayment penalty should be unenforceable as usurious when the sum of the actual interest paid plus the prepayment amount exceeds the maximum lawful interest rate calculated to the date of prepayment.[102] Courts have rejected this argument on the ground that the voluntary payment of the loan by the borrower was not a charge for the use of the money, but instead a charge for the privilege of repaying the loan before maturity.[103] The penalty may also be upheld when the payment by the borrower does not exceed the interest that would have been collected had the debt continued to its maturity, because the borrower is not required to pay more interest than it contractually agreed to pay.[104]

Another argument commonly rejected by the courts is premised upon the theory that the damages imposed do not bear a reasonable relationship to the injury caused by the prepayment.[105] This argument, whether framed in terms of invalid liquidated damages,[106] invalid penalty,[107] or unjust enrichment,[108] has proved unsuccessful in the voluntary payment situation. One court rejected the argument in part because the purpose of the prepayment penalty was to give the borrower the option to prepay.[109] Another court, in a commercial mortgage situation, based its decision

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[101] 49 Fed. Reg. 32,082 (1984).

[102] *See Secured Real Estate Loan Prepayment*, *supra* note 88, at 926.

[103] *See* Boyd v. Life Ins. Co. of the Southwest, 546 S.W.2d 132 (Tex. Civ. App. 1977).

[104] *See* Redmond v. Ninth Fed. Sav. & Loan Ass'n, 147 N.Y.S.2d 702 (N.Y. Sup. Ct. 1955).

[105] *See Update*, *supra* note 30, at 1055.

[106] *See* Meyers v. Home Sav. & Loan Ass'n, 38 Cal. App. 3d 544, 113 Cal. Rptr. 358 (1974).

[107] *See* Lazzareschi Inv. Co. v. San Francisco Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971).

[108] *See* Century Fed. Sav. & Loan Ass'n v. Madorsky, 353 So. 2d 868 (Fla. Dist. Ct. App. 1978). In this case, the court engaged in little analysis, instead quoting extensively from *Lazzareschi* as the justification for its decision. *Id.* at 869.

[109] Meyers v. Home Sav. & Loan Ass'n, 38 Cal. App. 3d at 546, 113 Cal. Rptr. at 359. This case is also interesting in that its companion case, Meyers v. Beverly Hills Federal Savings & Loan Association, 499 F.2d 1145 (9th Cir. 1974), concerned the same issue although with a federal savings and loan association chartered under HOLA, rather than a state lender. The court in the latter case did not reach the issue of the validity of the prepayment penalty under state law, instead basing its holding on the conclusion that state law was preempted by federal law. This case is discussed *infra* notes 186-88 and accompanying text.

on the fact that the prepayment penalty at issue did not exceed Board limitations upon the collection of prepayment penalties in the residential mortgage context.[110] Still another court upheld a prepayment penalty of fifty percent of the amount prepaid on the basis that the charge was reasonably related to the lender's risk.[111]

Prepayment penalties have also been attacked on the ground their use constitutes an invalid restraint on alienation.[112] Some courts have rejected this argument by refusing to view the prepayment charge as an exorbitant burden.[113] Other courts have viewed the assessment of the prepayment penalty as reasonably related to protecting the legitimate interest of the lender.[114] Some commentators, however, dispute that prepayment penalties do not constitute an invalid restraint on alienation.[115] Instead, they argue that when a lender invokes a prepayment penalty along with its exercise of the due-on-sale clause, alienation is restrained because of the increased cost of the conveyance.[116]

B. Limitations upon Prepayment Penalties

1. Judicial Treatment of Prepayment Penalties.—Although courts have often upheld prepayment penalties in the context of voluntary prepayments,[117] many courts have refused to enforce the penalties when the breach of the loan agreement resulted from an involuntary act on

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[110]*Lazzareschi*, 22 Cal. App. 3d at 309-10, 99 Cal. Rptr. at 421. The court noted that the prepayment clause in the subject commercial loan was the same as those permitted by the Board in home loans, and implied that the prepayment penalty of $9,130.02 would have been valid even if a greater amount had been charged because of the commercial nature of the loan. *Id.* The present day limitations imposed by the Board upon the collection of prepayment penalties in the residential mortgage context are found at 12 C.F.R. § 591.5(b) (1986).

[111]Williams v. Fassler, 110 Cal. App. 3d 7, 13, 167 Cal. Rptr. 545, 549 (1980).

[112]One commentator has classified prepayment penalty clauses and due-on-sale clauses as indirect rather than direct restraints upon alienation because they penalize transfers rather than prohibit them. *See Update*, *supra* note 30, at 1051.

[113]*See, e.g.*, *Lazzareschi*, 22 Cal. App. 3d at 311, 99 Cal. Rptr. at 422.

[114]Sacramento Sav. & Loan Ass'n v. Superior Court, 137 Cal. App. 3d 142, 186 Cal. Rptr. 823 (1982) (lender has a justifiable interest in imposing a prepayment penalty to cover his costs due to potential lag time and administrative processing prior to making a new loan); Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 546, 79 Cal. Rptr. 9 (1971) (lender has justifiable interest in imposing a prepayment penalty because of administrative costs incurred in issuing loans and setting up provisions for their servicing), *rev'd on other grounds sub. nom.* Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

[115]*See Update*, *supra* note 30, at 1051.

[116]*Id.* The author argued further that "there is no justification in law or public policy for the imposition of a penalty-type restraint upon alienation of the security." *Id.* at 1057.

[117]*See supra* notes 102-16 and accompanying text.

the part of the borrower.[118] As one commentator observed, "[W]here circumstances other than the [borrower's] deliberate exercise of the prepayment clause arguably have caused prepayment of the loan, the courts have examined the factual situations presented and have denied enforcement of the penalty where the [borrower] did not voluntarily mature the indebtedness."[119]

The rule prohibiting the collection of prepayment penalties upon the borrower's involuntary payment of the loan is applicable in several different situations. One situation occurs when the mortgaged premises are destroyed and the insurance proceeds are used to pay off the debt. In *Chestnut Corp. v. Bankers Bond & Mortgage Co.*,[120] the borrower's mortgaged premises were completely destroyed by fire. The loan documents provided that the debt could be prepaid at any monthly installment as long as the borrower paid an additional two percent penalty.[121] The court reasoned that the loan documents contemplated a voluntary prepayment by the borrower, and held that the lender was not entitled to the penalty when the mortgage debt was paid from the insurance proceeds after the premises were destroyed by fire.[122] The court noted that the lender could have protected itself by providing for a more explicit prepayment penalty in the loan documents.[123]

Another common situation in which courts have refused to authorize the collection of a prepayment penalty upon the involuntary payment of the loan, absent specific language in the mortgage or note, is when prepayment results from condemnation or the threat of condemnation of the mortgaged premises.[124] Thus, in *Jala Corp. v. Berkely Savings & Loan Association*,[125] the court held that the prepayment clause contemplated the borrower's voluntary exercise of its right to prepay the

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[118]*See, e.g.*, *In re* L.H.D. Realty Corp., 726 F.2d 327 (7th Cir. 1984).

[119]Annotation, *Construction and Effect as to Interest Due of Real Estate Mortgage Clause Authorizing Mortgagor to Prepay Principal Debt*, 86 A.L.R.3d 599, 605 (1978).

[120]395 Pa. 153, 149 A.2d 48 (1959).

[121]*Id.* at 155, 149 A.2d at 49.

[122]*Id.* at 156-57, 149 A.2d at 50.

[123]*Id.* The problems experienced by the lender in this case could have been avoided by drafting similar to that noted *infra* notes 221-24 and accompanying text. This is in fact what the court in *Chestnut* suggested.

[124]*See* Shavers v. Duval County, 73 So. 2d 684 (Fla. 1954); Associated Schools, Inc. v. Dade County, 209 So. 2d 489 (Fla. Dist. Ct. App. 1968); DeKalb County v. United Family Life Ins. Co., 235 Ga. 417, 219 S.E.2d 707 (1975), *on remand*, 136 Ga. App. 822, 222 S.E.2d 664 (1975); LandOhio Corp. v. Northwestern Mut. Life Mortgage & Realty Investors, 431 F. Supp. 475 (N.D. Ohio 1976); *cf. In re* Brooklyn Bridge Southwest Urban Renewal Project, 46 Misc. 2d 558, 260 N.Y.S.2d 229 (N.Y. Sup. Ct. 1965) (court held prepayment penalty was enforceable in the condemnation situation because the parties had expressly provided for such a happening in the loan documents).

[125]104 N.J. Super. 394, 250 A.2d 150 (1969).

balance of the mortgage and did not embrace prepayment by reason of eminent domain.[126] The court also found persuasive the argument advanced in *Chestnut* regarding the lender's ability to protect itself by express drafting.[127]

A third situation wherein courts have refused to enforce a prepayment penalty is the so-called "acceleration exception."[128] This situation arises when the lender exercises a due-on-sale clause and also attempts to collect a prepayment penalty upon the borrower's early payment of the loan.[129] Courts have commonly analyzed the lender's exercise of the due-on-sale clause as an advancement of the maturity date of the loan to the present.[130] Thus, a payment by the borrower upon the debt is not a prepayment, but rather a payment made after maturity, thereby precluding the lender's right to collect a prepayment penalty.[131]

The "acceleration exception" was recognized in *In re L.H.D. Realty Corp.*,[132] a case involving commercial property and a non-federally chartered lender. The loan documents provided for collection of a penalty in the event the loan was "prepaid."[133] The court began its analysis of the lender's attempt to impose a prepayment penalty after the lender had elected to accelerate the balance of the loan by recognizing that

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[126]*Id.* at 401, 250 A.2d at 154.

[127]The court reiterated the argument that had the lender believed itself entitled to a prepayment penalty in the event of condemnation, it could have provided for such an occurrence in the loan documents. *Id.*

[128]*See In re* L.H.D. Realty Corp., 726 F.2d 327 (7th Cir. 1984).

[129]Courts have upheld the lender's right to collect a prepayment penalty in situations related to the "acceleration exception." When the lender accelerates the balance of the loan, declaring it due, and then waives or rescinds its acceleration, courts have held that the lender may regain the right to collect a prepayment penalty. *See* Arend v. Great S. Sav. & Loan Ass'n, 611 S.W.2d 381 (Mo. Ct. App. 1981); West Portland Dev. Co. v. Ward Cook, Inc., 246 Or. 67, 424 P.2d 212 (1967); Berenato v. Bell Sav. & Loan Ass'n, 276 Pa. Super. 599, 419 A.2d 620 (1980). Thus, the lender's election to accelerate the loan need not be irrevocable. However, the lender's ability to rescind its election exists only where the borrower has not changed its position in reliance upon the lender's acceleration. *See* Van Vlissingen v. Lenz, 171 Ill. 162, 49 N.E. 422 (1898); *cf.* Great S. Sav. & Loan Ass'n v. Jefferson Properties, Inc., 661 S.W.2d 68 (Mo. Ct. App. 1983) (court rejected borrower's argument that waiver of acceleration had occurred as a matter of law).

[130]*See* Grubbs v. Houston First Am. Sav. Ass'n, 718 F.2d 694, 697 (5th Cir. 1983). *But cf. Update*, *supra* note 30, at 1050, where the author concluded that acceleration of the loan debt through use of a due-on-sale clause generates a "prepayment" for which a penalty is charged under the prepayment penalty clause.

[131]*See* General Motors Acceptance Corp. v. Uresti, 553 S.W.2d 660 (Tex. Civ. App. 1977) (holding that a "prepayment" is a payment made before maturity and "acceleration" is a change in the date of maturity from the future to the present).

[132]726 F.2d 327 (7th Cir. 1984). This case was somewhat complicated by the fact the borrower was in a Chapter 11 bankruptcy proceeding.

[133]*Id.* at 329.

reasonable prepayment penalties were enforceable.[134] It noted an exception to this general rule where the lender elects to accelerate the debt "because acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."[135] Noting that the lender had in fact accelerated the loan debt, the court held that payment of a prepayment penalty by the borrower would clearly be improper because the loan debt was presently due and the loan documents provided for a penalty only if the loan were "prepaid."[136] The court concluded that the lender's attempted collection of a penalty, in lieu of forgone interest, was improper because the lender had "voluntarily waived the unpaid interest in the expectation of accelerated payment of the remaining principal."[137]

Other cases involving commercial loan situations and non-federal lenders have applied similar reasoning to conclude the lender was not entitled to a prepayment penalty upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause.[138] However, in *George H. Nutman, Inc. v. Aetna Business Credit, Inc.*,[139] another case involving commercial property and a non-federal lender, the court employed a different analysis in refusing to uphold the lender's right to collect a prepayment penalty after acceleration of the balance of the loan. The court analogized to the involuntary exceptions of "eminent domain" and "payment of the mortgage debt through insurance proceeds" mentioned previously.[140] It reasoned that the lender's election "to treat the mortgage debt as due was not a voluntary act by the [borrower] sufficient to bring the prepayment penalty into operation."[141] Accordingly, the lender was not entitled to a prepayment penalty.[142]

Courts have also refused to allow federal savings and loan associations to collect a prepayment penalty upon acceleration of the mortgage

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[134]*Id.* at 330.

[135]*Id.* at 330-31.

[136]*Id.* at 331.

[137]*Id.*

[138]*See* Martin v. Southern Atl. Inv. Corp., 160 Ga. App. 852, 287 S.E.2d 692 (1982) (court held non-federally chartered lender was not entitled to collect a prepayment penalty upon commercial property when it exercised a due-on-sale clause). *Accord* Casey v. Business Men's Assurance Co., 706 F.2d 559 (5th Cir. 1983); McCarthy v. Louisiana Timeshare Venture, 426 So. 2d 1342 (La. Ct. App. 1982), *cert. denied*, 433 So. 2d 163 (La. 1983); *cf.* Grubbs v. Houston First Am. Sav. Ass'n, 718 F.2d 694 (5th Cir. 1983) (court held non-federally chartered residential lender should not collect a prepayment penalty upon acceleration of the balance of the loan because acceleration caused the loan debt to become immediately due).

[139]115 Misc. 2d 168, 453 N.Y.S.2d 586 (N.Y. Sup. Ct. 1982).

[140]*See supra* notes 118-27 and accompanying text.

[141]115 Misc. 2d at 169, 453 N.Y.S.2d at 587.

[142]*Id.*

debt pursuant to the exercise of a due-on-sale clause.[143] The decisions, which have employed reasoning similar to that previously discussed, make no mention of Board limitations upon the collection of a prepayment penalty in the residential mortgage context.[144]

2. State Legislative Treatment of Prepayment Penalties.—State legislatures have also addressed the issue of prepayment penalties, and several have enacted legislation regulating and often limiting their collection.[145] However, these statutes are limited to residential loans and do not attempt to regulate prepayment penalties in the commercial mortgage context.[146] The New Jersey statute forbids prepayment penalties in residential mortgages.[147] Pennsylvania's statute is similar.[148] Illinois prohibits prepayment penalties on residential loans with interest rates exceeding eight percent per annum.[149] Other legislation is not quite as restrictive. For example, Missouri allows prepayment penalties on residential mortgages during the first five years of the loan, but limits the penalty to two percent of the balance at the time of prepayment.[150] After five years, prepayment penalties may not be charged.[151] Mississippi also forbids prepayment penalties on residential mortgages after five years.[152] If prepayment is made during the first year of the mortgage, the prepayment charge is five percent of the unpaid balance.[153] The charge then decreases one percent per year.[154] California forbids prepayment penalties upon residential mortgages after five years as well.[155]

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[143]*See* Tan v. California Fed. Sav. & Loan Ass'n, 140 Cal. App. 3d 800, 189 Cal. Rptr. 775 (1983) (held that in residential mortgage context, federal lender could not collect a prepayment penalty upon its acceleration of the loan because the loan documents provided for a penalty only in the event borrower voluntarily prepaid the loan; court chose to ignore pertinent Board regulations); Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 98 Ill. App. 3d 646, 424 N.E.2d 939 (1981) (held that in commercial mortgage context, federal lender could not collect a prepayment penalty under the loan documents because borrower's payment upon lender's acceleration of the loan was not a prepayment; pertinent Board regulations not analyzed); American Fed. Sav. & Loan Ass'n v. Mid-America Service Corp., 329 N.W.2d 124 (S.D. 1983) (held that in mortgage upon "certain real property," federal lender could not collect prepayment penalty upon acceleration of the loan; Board regulations ignored).

[144]*See supra* note 143.

[145]These states include Illinois, Massachusetts, Mississippi, Missouri, New Jersey, New York, Pennsylvania, and West Virginia.

[146]*See infra* notes 147-61 and accompanying text.

[147]N.J. Stat. Ann. § 46:10B-5 (West 1986).

[148]Pa. Stat. Ann. tit. 41, § 405 (Purdon 1986).

[149]Ill. Ann. Stat. ch. 17, para. 6404(2)(a) (Smith-Hurd 1986).

[150]Mo. Ann. Stat. § 408.036 (Vernon 1986).

[151]*Id.*

[152]Miss. Code Ann. § 75-17-31 (Supp. 1986).

[153]*Id.*

[154]*Id.*

[155]Cal. Civil Code § 2954.9(b) (West 1986).

within five years, it imposes limitations similar to those of previous Board regulations.[156] Virginia provides that a borrower from a credit union may prepay at any time without penalty.[157] Virginia's statutes also provide that in the residential mortgage situation, the lender is not entitled to a prepayment penalty greater than two percent of the amount of the prepayment,[158] and may not collect a penalty at all if the payment results from the exercise of a due-on-sale clause.[159] New York also prohibits collection of prepayment penalties where the lender exercises a due-on-sale clause in a residential mortgage.[160] Massachusetts prohibits prepayment penalties where a residential mortgage is paid pursuant to the state's exercise of its eminent domain powers.[161]

3. Board Treatment of Prepayment Penalties.—The Board, which governs all federally-chartered savings and loan institutions, imposes restrictions on the enforcement of prepayment penalties upon residential mortgages in several situations. The lender may not impose a penalty if: (1) it declares by written notice that a loan is due pursuant to a due-on-sale clause;[162] (2) it initiates a judicial or nonjudicial foreclosure proceeding to enforce a due-on-sale clause;[163] or (3) it fails to consent within thirty days to the written request of a qualified purchaser to assume the loan according to its terms and thereafter the borrower sells or transfers the property and prepays the loan in full.[164]

In the preamble to the final publication of the Board's recent amendment of the above provisions,[165] the Board noted several pertinent justifications for limiting a lender's right to collect a prepayment penalty pursuant to the exercise of a due-on-sale clause. The Board stated that "equity demands that no prepayment penalty be permitted if a lender does not wish to allow a loan to remain outstanding by approving its assumption by a qualified obligor."[166] The Board effectively rebuffed

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[156] The statute provides:

> A prepayment charge may be imposed on any amount prepaid in any 12-month period in excess of 20 percent of the original principal amount of the loan which charge shall not exceed an amount equal to the payment of six months' advance interest on the amount prepaid in excess of 20 percent of the original principal amount.

Id.

[157] VA. CODE ANN. § 6.1-330.28 (1983).

[158] *Id.* § 6.1-330.29

[159] *Id.*

[160] N.Y. REAL PROPERTY LAW § 254-a (McKinney 1986).

[161] MASS. GEN. LAWS. ANN. ch. 183, § 57 (West 1977).

[162] 12 C.F.R. § 591.5(b)(2)(i) (1986).

[163] *Id.* § 591.5(b)(2)(ii).

[164] *Id.* § 591.5(b)(3).

[165] 50 Fed. Reg. 46,744 (1986).

[166] *Id.* at 46,746.

the lender's arguments in favor of the practice by noting "that the ability to impose a prepayment penalty is not essential to the effective use of due-on-sale clauses for the purposes of raising portfolio yields to current market interest rates."[167]

The Board's limitations upon the collection of prepayment penalties are limited to "loan[s] on the security of a home occupied or to be occupied by the borrower."[168] The Board imposes no limitations upon a lender's right to exercise a due-on-sale clause and collect a prepayment penalty in a commercial mortgage situation. However, many of the Board's justifications for restrictions upon the collection of a prepayment penalty in the residential mortgage situation seem equally applicable to the commercial situation. Neither commercial nor residential lenders should be allowed to engage in unequitable practices, especially when the practices are not required to bring their portfolio yields to current rates.[169]

IV. Application of Board Regulations, State Law and Policy Considerations to Commercial Lenders

A. *Board Regulation of Prepayment Penalties: Does Preemption Apply?*

De la Cuesta and the Act have, for the most part, settled questions as to a lender's ability to enforce a due-on-sale clause. However, the lender's ability to enforce a prepayment penalty in commercial mortgages, especially upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause, is not quite so settled.

Several Board regulations may apply to commercial mortgages. One such regulation, 12 C.F.R. § 545.34(c), provides that "an association

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[167]*Id.* at 46,745.

[168]12 C.F.R. § 591.5(b) (1986).

[169]A future problem may exist in the Board's enforcement of the limitations upon collection of a prepayment penalty. The regulations purport to limit the rights of "lenders" to collect prepayment penalties in certain situations. *See id.* § 591.5(b)(2), (3). Under 12 C.F.R. § 591.2 (1986), "lender" is defined as "a person or government agency making a real property loan, including without limitation, individuals, Federal associations, state-chartered savings and loan associations, national banks, state-chartered banks and state-chartered mutual savings banks . . . ." Thus, the Board attempts to prohibit all lenders, whether federally chartered or not, from collecting prepayment penalties pursuant to exercise of a due-on-sale clause. However, the Act upon which the Board relied for authority contains no language granting the Board authority to extend prepayment penalty enforcement limitations to non-federally chartered lenders. For the Board's purported source of authority, see Senate Comm. on Banking, Housing and Urban Affairs Report on S. 2879, S. Rep. No. 536, 97th Cong., 2d Sess., at 21 (1983).

may impose a penalty on prepayment of a loan as provided in the loan contract."[170] Another regulation provides:

> Section 545.34(c) makes clear that, with the exception of certain instances enumerated therein, the charging of a prepayment penalty is a matter of contract between a Federal association and a borrower, and that the borrower may wholly or partly prepay the loan without penalty unless the loan contract contains an express provision imposing a prepayment penalty. Thus, in view of the controlling Federal regulation, a Federal association may include a prepayment provision in the loan contract up to the maximum limitation of § 545.34(c) regardless of conflicting State law which sets a lower limit or imposes a different type of prepayment penalty, but it may not charge a prepayment penalty exceeding the limit in § 545.34(c) even if State law allows a higher charge.[171]

The effect of these regulations upon the ability of a federal association to collect a prepayment penalty is unclear. In particular, because 12 C.F.R. § 545.34(c) is entitled "Limitations for home loans secured by borrower-occupied property,"[172] its application to commercial mortgages seems questionable.

Pursuant to its "plenary and exclusive authority . . . to regulate all aspects of federal associations," the Board has expressed its intention to preempt "any state law purporting to address the subject of the operations of a Federal association."[173] However, in *de la Cuesta*, the Supreme Court narrowly limited the effect of its decision to the due-on-sale clause context. Specifically, the Court stated that "[b]ecause we find an actual conflict between federal and state law, we need not decide whether the HOLA or the Board's regulations occupy the field of due-

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[170] The full text of the regulation provides:

> (c) Loan payments and prepayments. Except for loans to natural persons secured by borrower-occupied property and on which periodic advances are being made, payments on the principal indebtedness of all loans on real estate shall be applied directly to reduction of such indebtedness, but prepayments made on an installment loan may be reapplied from time to time wholly or partly to offset payments which subsequently accrue under the loan contract. Subject to the disclosure provisions of § 545.33(f)(2), an association may impose a penalty on prepayment of a loan as provided in the loan contract. Notwithstanding the above, for any home loan secured by borrower-occupied property and on which the yield may be adjusted pursuant to § 545.33(e), an association may not impose a penalty on any prepayment made within 90 days following notice of an adjustment.

12 C.F.R. § 545.34(c) (1986).

[171] *Id.* § 555.15.

[172] *Id.* § 545.34(c).

[173] *See id.* § 545.2.

on-sale law or the entire field of federal savings and loan regulation."[174] The Court also hinted that the Board's preemptive powers were limited when it observed that "[a]lthough the Board's power to promulgate regulations excepting federal savings and loans from the requirements of state law may not be boundless, in this case we need not explore the outer limits of the Board's discretion."[175]

These statements must be contrasted with several seemingly contradictory statements in the Court's opinion. At one point, the Court observed that "[t]he Board's extensive regulations govern . . . loan payments and prepayments."[176] In another footnote, the Court cited approvingly *Meyers v. Beverly Hills Federal Savings & Loan Association*,[177] a decision holding that Board regulations preempted the entire field of prepayments of real estate loans to federal associations.[178]

In what could be characterized as an attempt to clarify the majority's contradictory indications, Justice O'Connor concurred separately emphasizing "that the authority of the Federal Home Loan Bank Board to preempt state laws is not limitless."[179] Conceding that the Board's powers were indeed broad, Justice O'Connor refused to recognize that HOLA allowed the Board to preempt all state and local laws applicable to federally-chartered savings and loan institutions.[180]

Justices Rehnquist and Stevens dissented. Arguing that contract and real property law were traditionally state law questions,[181] and that Congress had not intended to create a federal common law of mortgages,[182] Justice Rehnquist concluded his dissent by noting that "[d]ischarge of its mission to ensure the soundness of federal savings and loans does not authorize the . . . Board to intrude into the domain of state property and contract law that Congress has left to the States."[183] The only clear conclusion from the above discussion seems to be that a federal lender's ability to collect a prepayment penalty in the commercial mortgage context, absent specific language so providing, is unsettled.[184]

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[174]458 U.S. at 159 n.14.

[175]*Id.* at 167.

[176]*Id.* at 167 n.20.

[177]499 F.2d 1145 (9th Cir. 1974) *cited in de la Cuesta*, 458 U.S. at 152 n.9.

[178]499 F.2d at 1147.

[179]458 U.S. at 171 (O'Connor, J., concurring).

[180]*Id.* at 172.

[181]*Id.* at 174 (Rehnquist, J., dissenting).

[182]*Id.*

[183]*Id.* at 175.

[184]In contrast to the confusion surrounding the issue of whether the regulation of prepayment penalties is preempted by federal law, several examples exist of congressional action clearly preempting state law. The first of these is the previously mentioned Act, which preempted state law restrictions upon the enforcement of due-on-sale clauses. Another is the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C.

Only two lower court decisions address the Board's preemptive powers regarding prepayment penalties; however, both of these decisions involved residential mortgages.[185] The first of these, *Meyers*, cited approvingly by the Supreme Court in *de la Cuesta*,[186] involved a class action on behalf of borrowers holding "real estate loans" who sought to have prepayment penalty provisions in their loan contracts with federal lenders declared void as invalid liquidated damage clauses under a California statute.[187] The Ninth Circuit, while required by the circumstances of the case to determine only whether a specific federal regulation providing for prepayment penalties in fact conflicted with and therefore preempted a specific state statute, instead chose to base its holding upon much broader grounds. The court held that federal law preempted the entire field of prepayment penalties to federal lenders in "real estate loans" and, because of this, that all state laws were inapplicable.[188]

A second case interpreting the Board's preemptive powers over the collection of prepayment penalties by federal lenders in residential mortgages is *Toolan v. Trevose Federal Savings & Loan Association*.[189] In *Toolan*, the Pennsylvania Supreme Court employed a preemption analysis similar to that used by the Supreme Court in *de la Cuesta* to determine whether a state statute prohibiting prepayment penalties in residential mortgages was preempted by contradictory federal regulations providing for prepayment penalties.[190] Focusing upon statements in *de la Cuesta* supportive of prepayment penalty preemption,[191] and ignoring the Supreme Court's expressions of doubt upon the issue,[192] the *Toolan* court held that the regulation of prepayment penalties was within the Board's power and that the Board regulations did preempt the contradictory state statutes.[193]

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§ 1735f-7 (1982 & Supp. 1985), which preempted state usury laws for all "federally-related" loans secured by first liens on residential real estate. The Board regulations issued under the authority of this statute may be found at 12 C.F.R. §§ 590.1-590.101 (1986). A third example of a clearly preemptive statute is the Alternative Mortgage Transactions Parity Act of 1982, 12 U.S.C. §§ 3801-3805 (1982 & Supp. 1985), which authorized state chartered financial institutions to make alternative forms of mortgage loans approved by federal financial regulatory agencies, even though the loans might be contrary to state law.

[185]While both of these decisions address the preemption issue in the residential mortgage context, undoubtedly commercial lenders will apply similar reasoning in litigation involving prepayment penalties assessed in the commercial mortgage context.

[186]*See supra* notes 177-78 and accompanying text.

[187]499 F.2d at 1146.

[188]*Id.* at 1147.

[189]501 Pa. 477, 462 A.2d 224 (1983).

[190]*Id.* at 481-83, 462 A.2d at 226-27.

[191]*See supra* notes 176-78 and accompanying text.

[192]*See supra* notes 174 and 175 and accompanying text.

[193]501 Pa. at 484, 462 A.2d at 227.

Undoubtedly, federally-chartered savings and loan associations will argue that the reasoning of *Meyers* and *Toolan* should be extended to include the collection of prepayment penalties in the commercial mortgage context as well. Should future courts conclude that state laws concerning the collection of prepayment penalties by federal lenders are preempted by federal law, it is still not clear that federal lenders will be entitled to per se collection of a prepayment penalty pursuant to the exercise of a due-on-sale clause. If the Board regulations providing that prepayment penalties are "a matter of contract between a Federal association and a borrower"[194] and that prepayment penalties may be imposed "as provided in the loan contract"[195] apply to commercial loans, and if the Board's limitations upon the collection of prepayment penalties in residential mortgages[196] do not, may any other limitations upon the collection of prepayment penalties apply?[197]

The only applicable comment by the Board about prepayment penalties in commercial mortgages was included in the preamble to the final publication of the Board's amendment to 12 C.F.R. § 591.5(b).[198] There, responding to a query from an Indianapolis-based lender,[199] the Board stated that "[f]ederal associations may include prepayment penalty clauses in any loan they make and, except for limitations imposed by Board regulations, enforce such clauses according to their terms, state law—including equitable principles—notwithstanding."[200] If courts chose to view this statement by the Board as preemptive of state law,[201] it would seem that a federally-chartered lender could collect a prepayment penalty in a commercial mortgage situation even if the loan were paid as the result of a nonvoluntary payment by the borrower. The nonvoluntary exceptions to enforcement of prepayment penalties have been termed "equitable applications" of the law[202] and would likely fall within the category of state laws preempted under the Board's interpretation.

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[194]12 C.F.R. § 555.15 (1986).

[195]*Id.* § 545.34(c).

[196]*Id.* § 591.5(b)(2), (3).

[197]Of course, these types of questions will not arise under present law if the lender has effectively drafted its loan documents to preclude such problems. *See infra* notes 221-24 and accompanying text.

[198]*See* 12 C.F.R. § 591.5(b) (1986), as amended at 50 Fed. Reg. 45,749 (1985).

[199]*See* Office of General Counsel Opinion Letter (Oct. 9, 1985) (construing 12 C.F.R. §§ 545.34(c), § 591.5(b)(2) (1985)).

[200]50 Fed. Reg. 46,745 (1985).

[201]*See* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 159 n.13 (1982); Indiana Bell Telephone Co. v. Boyd, 421 N.E.2d 660 (Ind. Ct. App. 1981).

[202]*See* American Fed. Sav. & Loan Ass'n of Madison v. Mid-America Service Corp., 329 N.W.2d 124 (S.D. 1983).

B. *The "Acceleration Exception"*

While the above discussion may seem to preclude objections to a lender's imposition of a prepayment penalty pursuant to the exercise of a due-on-sale clause in the commercial mortgage context, the "acceleration exception" may still provide borrowers some hope. Under the reasoning employed by the Seventh Circuit in *In re L.H.D. Realty Corp.*,[203] acceleration of the loan by the lender pursuant to the exercise of a due-on-sale clause advances the maturity date of the loan so that payment thereafter is not prepayment but rather is payment made after maturity.[204] If the loan documents in a given case call for the payment of a prepayment penalty when the loan is "prepaid"[205] or when the loan is "paid before maturity," it would seem that even a federal lender would be precluded from collecting a prepayment penalty. This is because the Board regulations provide that collection of a prepayment penalty is "a matter of contract"[206] and that a prepayment penalty may be imposed "as provided in the loan contract."[207] If the loan documents provide for a penalty when the loan is paid before maturity, then under the contract, no penalty would be due because the loan may no longer be paid before maturity. The lender's acceleration of the loan pursuant to its exercise of the due-on-sale clause renders the loan presently due and makes payment of a prepayment penalty impossible.[208] Depending upon whether the court chooses to view the "acceleration exception" as an application of the involuntary exceptions to the collection of prepayment penalties or as a matter of contractual interpretation of the loan documents, a federally-chartered lender may be precluded from enforcing a prepayment penalty upon acceleration of the loan debt pursuant to the exercise of a due-on-sale clause.

Regardless of how courts resolve the problems applicable to federal lenders mentioned above, it appears those lenders not chartered under HOLA[209] and therefore not subject to Board regulation remain subject to state law limitations upon the collection of prepayments penalties. Therefore, the involuntary exceptions to prepayment penalty enforcement, along with the "acceleration exception," may still prevent non-federally

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[203] 726 F.2d 327 (7th Cir. 1984).

[204] *Id.* at 330-31.

[205] *See* McCarthy v. Louisiana Timeshare Venture, 426 So. 2d 1342 (La. Ct. App. 1983) (providing for a penalty in the event the loan is "prepaid"), *cert. denied*, 433 So. 2d 163 (La. 1983).

[206] 12 C.F.R. § 555.15 (1986).

[207] *Id.* § 545.34(c).

[208] *See L.H.D.*, 726 F.2d at 330-31.

[209] *See supra* notes 12 and 16.

chartered commercial lenders from imposing a prepayment penalty in some situations.[210]

V. What Next?

A. Policy Considerations

The Board regulations limiting the lender's right to collect a prepayment penalty in the residential mortgage context were prompted by consumer protests against unfair "double-dipping" practices of lenders.[211] While lenders often impose large prepayment penalties to discourage early payments of loans when market interest rates drop, they also exercise due-on-sale clauses when market interest rates rise above interest rates on existing mortgages.[212] The unfairness occurs when the lender elects to accelerate the balance of the loan debt pursuant to a due-on-sale clause, while also imposing a prepayment penalty.

This practice seems particularly unfair when the interest rate upon the existing mortgage is lower than the current market interest rates and when the lender's security interest is not endangered because a qualified borrower desires to assume the loan.[213] The lender's imposition of a prepayment penalty in this situation is unsupportable by any justification. The Board advanced similar reasoning when it "noted that the ability to impose a prepayment penalty is not essential to the effective use of due-on-sale clauses for the purpose of raising portfolio yields to current market interest rates."[214] While this comment was included in the preamble to the Board's amendment of regulations concerning the collection of prepayment penalties in residential mortgages, it is equally applicable to the commercial situation as well.

Regulation by the Board or, more preferably, legislation by Congress is warranted to clarify the confusion surrounding a federally-chartered lending association's ability to collect a prepayment penalty upon acceleration of the loan debt pursuant to the exercise of a due-on-sale clause in the commercial mortgage situation. Future legislation should closely consider the policy arguments against the exercise of a prepayment penalty pursuant to the exercise of a due-on-sale clause in the residential mortgage situation.

The lack of need by lenders to employ prepayment penalties to make due-on-sale clauses effective for raising portfolio yields to current market

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[210]*See* Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 98 Ill. App. 3d 646, 424 N.E.2d 939 (1981).

[211]*See Prepayment Penalties*, *supra* note 5, at 850.

[212]*See* Real Estate Finance, *supra* note 7, § 6.1.

[213]Under Board regulations, a borrower desiring to assume a residential mortgage is qualified if he "qualifies for the loan under the lender's applicable underwriting standards and . . . occupies or will occupy the security property." 12 C.F.R. § 591.5(b)(3) (1986).

[214]50 Fed. Reg. 46,745 (1986).

interest rates is one consideration.[215] Another argument advanced in the residential mortgage situation is that the prepayment penalty clause is not freely bargained for by substantially equal contracting parties.[216] Residential borrowers may not even be aware of what a prepayment penalty clause is, or they may be unable sufficiently to digest unintelligible loan documents to recognize its existence, much less be in a position to negotiate with lenders as to its inclusion within a mortgage. This argument would seem to be weakened in the commercial mortgage context because, arguably, parties to a commercial transaction freely contract. Both the borrower and the lender are often represented by counsel in commercial situations.[217] While representation by counsel might preclude a non-bargaining argument by borrowers, this is not necessarily so. Lenders are often in a financially superior position when negotiations commence, especially in today's economic climate of low market interest rates.[218] Many lenders have mortgages with high rates of interest on their books.[219] A borrower may possess little or no power to negotiate as to the existence or non-existence of prepayment penalties. Though the transaction be commercial, the prepayment penalty provision may not be "freely bargained for."

The collection of a prepayment penalty upon acceleration of the loan debt pursuant to the exercise of a due-on-sale clause may create an inequitable windfall for the lender, whether in the residential or commercial mortgage context. If part of the justification for due-on-sale clauses is that they enable lenders to call in loans with below market interest rates so that lenders may loan the funds at currently higher rates of interest, it seems fair and just that a borrower should be permitted to prepay its loan without penalty when market interest rates drop below previous levels.[220] This argument is further strengthened by the fact that the borrower's early payment of the loan is not voluntary, but results from the lender's command that the loan be paid off. This "double-dipping" practice by lenders is unfair and should be limited by Board or Congressional action.

B. *Express Drafting to Avoid Problems*

Notwithstanding the above discussion, and absent a non-preempted state statute providing to the contrary, lenders may employ express drafting to avoid many of the problems associated with collection of a

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[215]*Id.*

[216]*See Prepayment Penalties*, *supra* note 5, at 851.

[217]One might question the business sense of either a borrower or lender entering into a major commercial transaction without the benefit and assistance of competent counsel.

[218]*See supra* text and accompanying notes 1-4.

[219]*See supra* text and accompanying notes 1-4.

[220]49 Fed. Reg. 32,082-83 (1984).

prepayment penalty upon acceleration of the loan, if they do not do so already. Express drafting was successfully employed by a commercial lender in *Lazzareschi Investment Co. v. San Franscisco Federal Savings & Loan Association*.[221] In *Lazzareschi*, the lender imposed a penalty of $9,130.02 upon the borrower's early payment of the loan.[222] Although the lender was able to reloan the recovered funds at higher market interest rates, the court upheld a prepayment clause that provided: "The undersigned agree that such six (6) months advance interest shall be due and payable whether said prepayment is voluntary or involuntary, including any prepayment effected by the exercise of any acceleration clause provided for herein."[223] Another express clause that has been upheld stated: "[I]f the loan is paid in full prior to maturity then in addition to the interest due, the holder hereof shall have the right to charge a sum equal to three months advance interest on the principal balance."[224]

Thus in situations where the loan documents expressly provide for a prepayment penalty, the court is more likely to uphold the penalty against possible restrictions upon collection based upon grounds of involuntary payment or other policy considerations. This is especially so in the commercial mortgage situation, because arguably the parties have freely contracted.

VI. Conclusion

Under present Board regulations, a lender may not collect a prepayment penalty upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause in the residential mortgage context. The residential lender is also precluded from imposing a prepayment penalty when he refuses to allow a "qualified transferee" to assume the loan in accordance with the loan's terms. A commercial lender's ability to enforce a prepayment penalty under the same circumstances is unclear in light of vague Board regulations and the Supreme Court's failure in *de la Cuesta* to address the issue of broad federal preemption of savings and loan law. Many of the equitable considerations prompting the Board's limitations upon collection of prepayment penalties in residential mortgages are equally applicable to the commercial mortgage situation.

Action by Congress, the Board, or both is warranted to eliminate this confusion. In view of the numerous policy considerations discussed previously, any action should be formulated such that commercial bor-

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[221] 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971).
[222] *Id.* at 306, 99 Cal. Rptr. at 419.
[223] *Id.* at 305, 99 Cal. Rptr. at 418.
[224] Arend v. Great S. Sav. & Loan Ass'n, 611 S.W.2d 381, 382 (Mo. Ct. App. 1981).

rowers are afforded the same protections against inequitable imposition of prepayment penalties by lenders as residential borrowers are afforded under present Board regulations. Thus, commercial lenders should be prohibited from imposing a prepayment penalty pursuant to the exercise of a due-on-sale clause.

Regardless of any future action by Congress or the Board, lenders must be conscious of the pitfalls awaiting carelessly or loosely drafted loan documents. Under present law, careful thought and express drafting may easily avoid the problems mentioned in this Note.

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